policy studies

#14

New economic legislation, 1998-1999

In this issue, we provide an evaluation of changes in Ukrainian economic legislation that took place during the last 12 months. Legislation pertaining to regulation of economic activity, taxation, agriculture and the energy sector underwent significant modifications. Meanwhile, there were no key changes made in the realm of contract enforcement or stock market infrastructure. Ukrainian authorities should pay more attention to the development of legislation on protecting competition and intellectual property rights.

The past year's changes show incipient tendencies which will determine the further direction of Ukrainian legislative developments, i.e., adoption of new codes, coordination of current laws, and introduction of European standards.

december 2000

international centre for policy studies

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Overview

In this issue, we provide an evaluation of changes in Ukrainian economic legislation that took place during the last 12 months with regard to their impact on the business environment in Ukraine.[1] Given that first efforts were made to determine public policy priorities and to reach consensus on reforms, we suggest that in general legislation improved during this period. Meanwhile, key documents which should ensure the integrity of the legal framework in Ukraine–new civil, customs, and land codes–were not adopted

The past year's changes show incipient tendencies which will determine further directions of Ukrainian legislative developments; they include

- adoption of codes which will replace legislation dating to the Soviet period. The necessity of new civil and land codes emerged from the need for strengthening private ownership in the realm of property and land relations;
- reconcilement and improvement of current laws. Regarding legislation on taxation, the Tax Code should fulfil this function;
- development of legislation in line with European and WTO standards. These modifications will help to promote competition and therefore encourage business development and more effective resource allocation.

During the last year, legislation pertaining to the regulation of economic activity, taxation, agriculture, and the energy sector underwent significant changes. Meanwhile, there were no key changes made in the realm of contract enforcement or stock market infrastructure. Also, Ukrainian authorities should pay more attention to the development of legislation on protecting competition and intellectual property rights.

Changes in legislation on business regulation (see **REGULATION OF BUSINESS ACTIVITY**) were directed at determining the procedures for government agency actions and for their regulation. The goal of these modifications was to set quality market regulation. Procedures for drafting and approving regulatory acts were imposed, envisioning the evaluation of regulatory impact, and promoting public participation.

[1] An analysis of economic legislation changes made in 1998–1999 is presented in *Policy Studies*, #7–8 (July–August 1999).

The Law "On licensing" will guarantee easier procedures for new businesses entering the market. The law stipulates license-receiving procedures based on a declarative principle (rather than a permission-granting one). The draft laws on certification, standardisation, and accreditation, coordinated with EU standards, envision significant changes in the structure of executive bodies and a shift from compulsory to voluntary certification. These laws will encourage development of competition and higher quality of Ukrainian products.

However, legislative regulation of tax agency powers is the most acute problem. During the last 12 months, the powers of the State Tax Administration (STA) were significantly enlarged: in particular the STA was entitled to submit proposals regarding tax legislation and to dispose of property seized as tax collateral without the supervision of third parties. As a result, there are increased risks of inconsistent taxation policy and abuses of power (see **REGULATION OF BUSINESS ACTIVITY**).

At the same time, innovations in the tax system (tax list, rates, and bases) promoted economic growth: tax legislation became more stable, equality in tax burden distribution increased, and the tax burden was lessened (see **TAXATION POLICY**). These tendencies will be stronger when the Verkhovna Rada of Ukraine passes the Tax Code.

However, there is still no consensus on the degree of reduction of the VAT, corporate tax, and personal income tax rates. Uncertainty about the future taxation policy will persist until consensus is reached on the Tax Code regulations. The powers of tax agencies, the rights of taxpayers, and the mechanism of tax collateral are being actively discussed. The Tax Code should define these issues in detail.

Guided by the priority objectives stated in the EU Partnership and Cooperation Agreement and WTO requirements, Ukrainian authorities have introduced legislation changes directed at foreign trade liberalisation. Import duty rates were reduced and import restrictions were abolished. The draft Customs Code complies with WTO standards. These measures will simplify and correct the procedures for customs passage (see **FOREIGN TRADE**).

Meanwhile, protectionist measures remain without changes in the domestic metallurgical and automobile industries and in agriculture. They distort competition and force Ukraine's trade partners to apply compensatory sanctions.

According to the EU Partnership and Cooperation Agreement, the development of legislation on protection of competition is a priority objective of Ukraine. Today, this legislation is weak. Only first steps have been made to set control over maintaining fair competition in those spheres where market self-regulation is not able to promote competition. A framework law on natural monopolies was approved only in April 2000. The development of competition legislation will be guided by the aim of harmonising Ukrainian and European antimonopoly legislation (see **COMPETITION POLICY**).

Special economic zones (SEZ) threaten the development of competition in Ukraine (see **SPECIAL ECONOMIC ZONES**). The main problems of SEZ operation are lack of clear and strict requirements concerning SEZ specialisation; improperly large size of SEZ and priority development areas; and opaque and unclear procedures for entering/exiting and excessive regulation of SEZ entity activities.

Legislation on the protection of intellectual property rights is also an important factor for promoting fair competition (see **INTELLECTUAL PROPERTY**). Creating an integrated legal framework and ensuring law execution are the main objectives in this realm. Effective protection of intellectual property rights will encourage foreign investments into Ukraine and stimulate the creation of domestic intellectual property.

During the last year, legislation on contract enforcement underwent no changes. A new version of the Civil Code, passed second reading, was the most remarkable event of this period. The goal of the new code is to set uniform rules of the game in the realm of property relationships, on the basis of an even playing field for all business entities, and their freedom of choice to enter these relationships. However, the government and the Verkhovna Rada could not compromise regarding judicial system reform (see **CONTRACT ENFORCEMENT**).

During the last year, the legal framework regarding the stock market and its infrastructure was not improved. The main locomotive for stock market development is privatisation, which was accelerated thanks to several legislative instruments (see **PRIVATISATION AND THE STOCK MARKET**).

Finally, we evaluate modifications in agriculture, energy, and banking regulation.

Legislative and normative acts for the regulation of the agricultural sector that were adopted over the last twelve months

can be split into two groups: (1) documents that determine property rights and (2) documents that regulate activities in the agricultural market. All these documents have a common positive feature—the development of the agricultural sector based on market principles. The further development of the agricultural sector will significantly depend on the Land Code (see **SECTORAL REGULATION**).

Adoption of the amendment to the law "On electricity" was the main event in the realm of energy sector regulation. These amendments eliminate the majority of reasons for non-payments in the energy market, but simultaneously increase the rights of the government to interfere in the activities of wholesale electricity market agents.

The problems of banking regulation in Ukraine are instability and the requirement that they perform fiscal functions. Frequent changes in regulations, coupled with administrative measures, diminish the attractiveness of the banking sector for investors. Fiscal functions and the failure to maintain bank secrecy scare away potential clients. The law "On banks and banking activities" should eliminate these problems.

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The research was carried out with the financial support of the Canadian Cooperation Fund.

The above experts, and specialists of the Canadian Cooperation Fund, are not responsible for the evaluations and conclusions expressed in this paper.

Regulation of economic activity

Modifications in legislation on the regulation of economic activity are aimed at forming market mechanisms for self-regulation that should replace government interference in company operations. The continued use of mechanisms of direct administration–proven to be totally ineffective in the new economic environment–causes lost confidence in government policy, depressed business activity, and, as a result, growth of unemployment, increased budget losses at all levels, and slashed social programs

Regulatory policy

Principles

The government made its first efforts towards the development of an integrated regulatory policy. Procedures for drafting and substantiating regulatory acts were introduced, envisioning regulatory impact analysis and public participation in decision making

During the last 12 months, the government made its first efforts towards the development of an integrated regulatory policy. The President signed the Decree "On introducing an integrated regulatory policy in the business sector" on January 22, 2000. The decree establishes the following principles for the legal regulation of business activity:

- expediency, adequacy, and compliance of legal regulation with the requirements of market economy;
- positive economic and social impacts of imposed regulatory acts;
- consistent and coordinated measures to draft, impose, and execute regulatory acts;
- openness in developing the most important regulatory acts which strongly affect the market environment and the rights and interests of businesses and public discussions of these drafts;
- compulsory and timely notification of business entities about approved regulatory acts.

Also, the decree stipulates that draft regulatory acts must be agreed with the State Committee of Ukraine for Regulatory Policy and Entrepreneurship (STE) which is responsible for coordinating the work of executive bodies on drafting, imposing, and executing regulatory acts.

In order to increase the influence of civil society institutions on decision-making processes within the government, the decree states that draft regulatory acts affecting the market

environment and the rights and interests of business should be published to promote discussion.

The presidential decree was followed by the Cabinet of Ministers resolutions "On approving the Methodological recommendations on preparing substantiations for draft regulatory acts" dated May 6, 2000 and "On approving the Regulations on the procedure for drafting regulatory acts" dated July 31, 2000.

Regulatory impact analysis

According to the resolution dated May 6, 2000, draft regulatory acts submitted to the President and the government or adopted by central and local executive bodies should be accompanied by a regulatory impact analysis (RIA).

An RIA includes the following elements:

- description of the problem to be resolved through state intervention in certain business activities (why the problem cannot be resolved with the help of market mechanisms and calls for state intervention, what its harm is), and definition of the objectives of regulation;
- description of the mechanisms and measures to resolve the problem, with an explanation of why they will be effective;
- description of alternatives to the proposed regulatory act, which should include an assessment of other possible means of resolving the problem;
- analysis of the costs and benefits of the proposed regulatory act and the alternative regulations, and also the costs and benefits to citizens, businesses, and the state—i.e., the three groups directly or indirectly affected by the regulatory act;
- assessment of the forecast economic and social effects of the proposed regulatory act;
- rationale for the term of the proposed regulatory act and a list of measures to determine the degree of effectiveness of the regulatory act.

Procedures for drafting regulatory acts

The resolution dated June 31, 2000 establishes the procedures for drafting regulatory acts at the level of central and local governments and by the Crimean Council of Ministers.

The stages of drafting regulatory acts are as follows:

- planning work on the development of draft regulatory acts, and developing the drafts;
- analysing the regulatory impact according to the Methodological Recommendations on preparing the substantiation for draft regulatory acts, defined by the resolution dated May 6, 2000;
- coordinating drafts with the STE and/or its corresponding regional agencies; and submitting drafts for approval;
- implementing measures to determine the degree of effectiveness of imposed regulatory acts; and preparing reports on these measures.

The resolution also determines the procedures for coordinating draft acts with the STE and reviewing appeals on its decisions at government committee meetings.

According to the framework Presidential Decree "On measures to support business activity and its further development" dated July 15, 2000, executive bodies should "ensure the involvement of business associations in public discussions of draft regulatory acts". Two months before, thanks to active lobbying by business associations, the Cabinet of Ministers created the Council of Business Associations at the Government Committee on Economic Development.[2] The council is responsible for (1) providing independent analysis of draft documents being considered by the government committee, and (2) organising feedback between business associations and the government regarding the effectiveness of imposed regulations. The decree and resolutions of the Cabinet of Ministers both strengthen business influence on regulatory policy at a procedural level.

Meanwhile, the executive's lack of institutional capacity to maintain procedures for public discussion of alternative decisions results in inconsistency of government policy. For example, simultaneously with two decrees aimed at business development (dated January 22 and July 15, 2000), the President imposed the Decree "On additional measures to strengthen the fight against hiding untaxed incomes, and also laundering illegally earned profits" dated June 22, 2000.

[2] The council was created pursuant to a Cabinet of Ministers resolution dated May 18, 2000.

Contradicting the principles of regulatory policy, this decree provides for further enlargement of the powers of controlling agencies.

Entering and exiting the market

Free entry to the market is the main prerequisite of competition. The last year's decisions in general were directed at restricting the registration of business entities. However, a progressive law on licensing was approved

Free entry to the market is the main prerequisite of competition. Effective procedures for the registration and licensing of business entities encourage the legalisation and development of economic activity.

Registration of business entities

The Presidential Decree "On measures to ensure the redemption of debts to budgets and state targeted funds, and the repayment of loans" dated December 24, 1999 significantly complicated entry to the market. The President of Ukraine ordered the Cabinet of Ministers "through all possible legal means to restrict the creation of business entities by:

- individuals and legal entities which are founders (owners) or supervisors of business entities in arrears to budgets or state targeted funds, or having debts on loans granted under guarantee of the Cabinet of Ministers of Ukraine or local state administrations (hereinafter–debts);
- business entities having debts."

The danger of these regulations is that they violate the principle of limited liability of business owners. Moreover, they are applied even to small shareholders in open joint-stock companies, which form of ownership often emerged in the process of mass privatisation.

The liability of owners should be limited to their share of the authorised capital. That is why the full liability for company debts to creditors and budgets at all levels is assumed by the legal entity—the company—and its management. Expecting dividends, owners invest available money in their co-owned enterprises. They should monitor the activities of company management—hired employees—through supervisory boards and other statutory bodies. However, according to the decree dated December 24, 1999, the risk of economic activity is shifted from the hired managers to the owners. This could lead to the forced transformation of all legal entities into companies with full liability. This form of ownership is the least popular in the world, due to the very high level of liability. Thus, this step in Ukraine could mean an attempt to pre-

vent citizens from exercising their constitutional right to economic activity.

Licensing economic activity

This year, the Law "On licensing certain types of economic activity" dated June 1, 2000 drastically modified the permit system in Ukraine.

The new law is grounded on the following principles:

- declarative principle for obtaining licenses;
- protection of human rights, legal interests, and life and health, environmental protection, and national security;
- establishment of a single procedure for licensing economic activities throughout Ukraine;
- determination of a single list of licensable types of economic activity.

The legislation clearly defines the objects and subjects of licensing and licence conditions, and sets forth the procedures for granting licences and supervising the execution of licence conditions. The law minimises the possibilities for free interpretation of its provisions by state officials and, thus, corruption.

However, the law still contains weak points, which lead to certain risks:

- The list of activities requiring licensing is still rather excessive. It covers economic activities which do not meet the second declared principle of licensing.
- The scope of the law's application is restricted. The law does not touch certain types of economic activity—in particular, broadcasting, the power sector, and use of nuclear energy—which are licensed according to special laws. This creates a precedent for the violation of the basic principle of using a single list of activities requiring licensing and a single procedure for licensing.

In general, successful execution of the law will depend on the Cabinet of Ministers resolutions that determine conditions and fees for every type of activity. The law will significantly improve the regulatory environment if the said resolutions follow the rules that (1) licenses are not fiscal instruments, only documents of permission, and (2) licence conditions should cover only the specific activities requiring licensing.

Tax administration

The most painful for businesses in Ukraine problems are in the realm of tax administration. Enlarged powers of the tax agencies will not encourage simplified tax administration. A mechanism for collecting tax arrears, which is currently under consideration, has significant weak spots

The problems in the realm of tax administration are the most painful for businesses in Ukraine. This fact is confirmed by survey findings. According to the results of a survey on small businesses in Ukraine conducted by the International Finance Corporation,[3] businesses ranked the simplification of tax reporting, elimination of incentives for tax collection, and decreasing the powers of tax inspectors as the second, third, and fourth most important measures required in the realm of tax administration.

The Presidential Decree "On approving the Regulations on the State Tax Administration" dated July 13, 2000 is a notable move in this direction. Unfortunately, jointly with its positive features, the decree on tax administration entails large risks. The powers of the State Tax Administration on the most disputed issues were considerably enlarged; in particular:

- The State Tax Administration (STA) was again granted the right to submit its proposals regarding tax legislation without coordination with the Ministry of Finance, which is responsible for developing tax policy.
- The tax agency was yet again entitled to independently determine the procedures for inspection of financial and economic activity, as well as their frequency. This authority of the STA contradicts the Presidential Decree "On some measures to deregulate business activity";[4] this decree specifies when inspections can be carried out and when companies can turn away representatives of controlling bodies.
- The STA gained new functions that duplicate those of other executive bodies. For example, the STA can make decisions on creating, reorganising, liquidating state-owned enterprises, institutions, and organisations.

These regulations lead to conflicts of interest, since the agency which should be responsible only for monitoring execution of tax legislation obtains the possibility to manage business entities, and independently determine the rules of its own activity.

[3] The survey findings were published in June 2000.
[4] Presidential Decree dated July 23, 1998.

In the process of tax reform, work on the draft Tax Code and draft Law "On the procedures for collecting taxpayer debts to budgets and state targeted funds"[5] will play a most important role. The most recent draft was developed in order to improve the procedures guaranteeing tax payments. While the draft law describes clear mechanisms for collecting tax arrears, it has the following weak spots:

- Tax agencies are entitled to unilaterally sell any property seized as a tax collateral (including integrated property complexes). Thus, in fact, this procedure constitutes accelerated pre-court bankruptcy, but it does not meet the principles of effective bankruptcy.
- All enterprise assets which are not pledged at the moment when the tax debt arises should be seized as tax collateral if the taxpayers have not returned any tax forms at all (or late) and if taxpayers do not pay pre-approved tax liabilities; the tax administration is thus courting abuses.
- The possibility for calculating tax liability sums on the basis of indirect and analogy-based methods. The wide scope of powers of tax agencies in applying indirect methods leads to a risk that tax agencies will abuse them, and hence creates room for corruption.

Regulation of reporting and accounting

The problems of excessive reporting and accounting have become more acute. Financial accounting and statistical reporting have become unjustifiably complicated

The problems of excessive reporting and accounting are one of the largest obstacles to the development of business activity in Ukraine. During the last year, this sphere underwent some changes which only worsened the regulatory environment.

Financial accounting

Adoption of the Law "On amending the Law of Ukraine 'On using electronic cash registers and sales books in transactions with customers in trade, catering, and the services sector'" dated June 1, 2000 was the most resonant event in the realm of business regulation.

The law generates risks of enlarged room for corruption and a worsened regulatory climate in Ukraine. After numerous appeals on the part of businesses, including picketing, the

[5] A draft law is involved in the draft Tax Code (see Chapter 13 "On overall administrative regulations").

Verkhovna Rada postponed the date of the law's promulgation until January 1, 2001 in order to amend the law.

The most problematic regulations of the law are the following:

- The law is applied to both cash and non-cash transactions. That is, the use of cash registers can be required even in cases of money being transferred from the buyer's to the seller's current account, which is unsupportable.
- The requirement for using cash registers and/or accounting books even covers small-size businesses, which should be entitled to simplified methods of taxation, accounting, and reporting. Simplified taxation enables these businesses to pay fixed tax sums which do not depend on accounted incomes and costs, and it guarantees the budget revenues and simplifies tax administration. In contrast, financial accounting on the basis of documentary confirmation (e.g., cash registers or passbooks) is an excessive and very costly procedure for small businesses. It does not affect their budget contributions and kills any incentive for legal operations. This situation has already resulted in social tension and can cause large budget losses.
- The law establishes additional accounting requirements which will duplicate current forms of financial accounting and require extra resources; even insignificant mistakes in this accounting could lead to severe fines.
- Contrary to the regulatory policy declared by the President of Ukraine, the law includes the concept of an "operative" (on-the-spot or unscheduled) inspection. In practice, such inspections could be carried out without any reason and in any number, leading to excessive abuses and huge corruption.

A draft law on amending the abovementioned law has already been registered at the Verkhovna Rada. So, the described problems can potentially be resolved in the near future.

Statistical reporting

The Law "On amending the Law of Ukraine 'On state statistics'" dated July 13, 2000 does not encourage business development, either.

The law entitled statistical bodies to conduct inspections of the financial and economic activity of business entities. It allows "visiting shops, service and other premises, and sites owned by legal entities, their subsidiaries, branches, representative offices, and other separate departments, or individual entrepreneurs". Practically, this function of statistical bodies duplicates the powers of tax agencies.

The law also expands the requirements for statistical reporting to the smallest business entities. They are required to submit tax reports, though business entities following the simplified taxation system are exempted. These requirements generate excessive problems, both for the businesses and the statistics bodies. Performance indicators of small-size businesses are so petty, while their number is so huge, that the overall reporting translates into a very expensive and ineffective procedure. Evaluating the indicators of small-size businesses on the basis of sampling surveys would be more useful and effective.[6]

Regulation of product safety and quality

Currently, the Ukrainian system of technical regulation creates a heavy burden for manufacturers and suppliers. Draft laws "On the accreditation of agencies conducting compliance assessments", "On confirming compliance", and "On standardisation", which should fundamentally change the situation, have already passed first reading in the Verkhovna Rada

Currently, the Ukrainian system of technical regulation creates a heavy burden for manufactures and supplies. It impedes the development of new technology and obstructs the entry of domestic enterprises into international markets. The system of technical regulation involves standardisation, certification, and accreditation. This system is related to issues of producer responsibility for the quality and safety of their products, and the protection of consumers.

In Ukraine, the outdated system of technical regulation is fixed at a legislative level in two decrees of the Cabinet of Ministers—"On standardisation and certification" and "On state control over following standards, norms, and rules, and the responsibility for their violations", and also in numerous laws and by-laws. That is why, in order to improve the situation, a legal framework for reform should be created. Draft laws "On the accreditation of agencies conducting compliance assessments", "On confirming compliance", and "On standardisation" have already passed first reading in the Verk-

[6] This practice is generally adopted in the rest of the world. For more detail, see *Policy Studies* No. 13 (November 2000), titled "Economic statistics in Ukraine".

Verkhovna Rada. The system of technical regulation will be brought into line with the European system.

Standardisation

In developed counties, complying with standards is a matter of freedom of choice. Contrarily, in the Soviet Union, which had no competitive market, standards were mandatory and directed at ensuring a minimum level of product quality. In Ukraine, all standards are still mandatory. However, according to world practices, only standards stipulating requirements for human life and health safety and environmental protection should be mandatory.

Moreover, Ukraine still applies mandatory standards dating to the 1980s, '70s, and '60s. This policy impedes the development of technologies and hence reduces the country's export potential. Countries claiming associated membership in the European Union should harmonise not less than 80% of their standards to corresponding international and European norms. Ukraine has harmonised only 5% of its standards.

The draft law "On standardisation" establishes a legal framework for reform in the sphere of standardisation according to the abovementioned principles.

Certification

The goal of certification is fair inspections of product conformity to defined standards (mandatory or voluntary), conducted by the third parties which do not depend on the producers or consumers.

The findings of a survey carried out by the Regulatory Reform program in May 2000 show that in Ukraine the costs to producers related to certification have increased since 1998. Moreover, about 60% of producers must certify their goods.

According to Ukrainian legislation, only state bodies are entitled to certify products. As a result, the majority of these bodies are not able to function in a market environment, or promote voluntary certification. They are subordinated to ministries and lobby own interests. Such behaviour heaps a heavy burden on producers' shoulders. If enterprises buy modern equipment abroad, they must certify it—certification costs are often equivalent to the equipment value.

When the Verkhovna Rada adopts the Law "On confirming compliance", Ukraine will harmonise these procedures, including certification, with international principles. Practi-

cally, it will mean the legal introduction of EU guidelines on product safety (which are actively used by advanced countries of Central Europe). Thanks to these measures, the scope of mandatory certification and related producer costs will be significantly reduced in Ukraine. EU countries apply effective and flexible mechanisms for state regulation of product safety, reckoning the interests of both consumers and producers. Producers can choose different schemes of certification on the basis of their resources and types of products. In many cases, a sufficient condition is the producer's declaration showing that the products conform to defined standards. This method enables producers to develop and innovate technologies, conforming them exclusively to overall safety requirements rather than to specific standards.

Accreditation

Accreditation is the control of the competence of certification bodies in their sphere, conducted by authorised agencies on accreditation.

Agencies accrediting certification bodies should not be authorised to conduct certification. Otherwise, they would tend to accredit themselves in a conflict of interests. That is why in world practice, there is a requirement for delimiting the functions of accreditation and certification. This requirement is not fulfilled in Ukraine, where the Committee of Ukraine on Standardisation, Metrology, and Certification is responsible for both certification and accreditation.

The draft law "On the accreditation of agencies confirming compliance" envisions the creation of a Ukrainian national accreditation agency. It should be the agency aimed at Ukraine's accession to the European Association on Accreditation (EA) and the International Forum on Accreditation (IFA). This integration will ensure confidence in this agency and the bodies it accredits. This confidence will be reflected in the quality of services delivered by accredited bodies on certification and the products they certify. It will enable mutual recognition of the results of work on certification between Ukraine and other countries, which is now impossible due to the mistrust of developed countries of the Ukrainian system of technical standards, and violation of the principle of delimitation of functions of accreditation and certification in Ukraine. Mutual recognition will relieve Ukrainian exporters from double certification; today, they must certify their products in Ukraine and also in the West, which drastically increases product price.

Taxation policy

A tax system which would promote business in Ukraine should meet the following criteria: (1) stability and predictability of tax legislation, (2) equitable distribution of the tax burden, and (3) minimal losses for producers and consumers. Over the last year, this sphere underwent some positive moves, including increased stability of tax legislation; improved equality in taxation due to the abolition of certain tax privileges and the ban on tax debt restructuring; and reduced tax burden through the cancellation of some taxes. These tendencies will be stronger when the Verkhovna Rada of Ukraine passes the proposed draft Tax Code. However, the Tax Code will not be able to solve certain contradictions, particularly concerning the powers of tax agencies, the rights of taxpayers, and the mechanism of tax collateral

Stability of tax legislation

During this year, tax legislation became generally more stable. However, the most unstable element of tax legislation remains excise taxation

Ukrainian tax legislation became more stable thanks to the following factors:

- During the last year, according to legislation, the Verkhovna Rada was the only authority to make decisions regarding tax list, rates, and bases.[7]
- According to the Presidential Decree "On the Regulations on the Ministry of Finance of Ukraine" dated August 26, 1999, the power to develop tax policy was delegated from the State Tax Administration to the Ministry of Finance. This move improves the process of bringing fiscal and tax policies into line. However, one year later, another presidential decree expanded the powers of the State Tax Administration to initiate new legislation;
- Improved decision-making procedures in the government (i.e., creation of government committees and approval of the government's work agenda[8]) diminished the probability of decisions being adopted that do not correspond to the consistent strategy of the government.

[7] See the Law of Ukraine "On the procedure for setting tax rates and levies (compulsory payments), and other elements of tax bases, and also tax privileges" dated October 14, 1998, and *Policy Studies*, #7–8 July–August 1999), p. 18

[8] See the Cabinet of Ministers resolutions "On government committees" dated February 17, 2000 and "On approval of an Interim Agenda of the Cabinet of Ministers of Ukraine" dated June 5, 2000.

During the past year, like in 1998–1999, the most unstable element of tax legislation was excises; authorities made changes in excise rates, initiated temporary privileges and exemptions from excise payment, and revised the terms of privileged rates as well. However, contrary to previous years, decisions on such changes were made exclusively by the Verkhovna Rada—the President or the Cabinet of Ministers no longer have rights to set excise rates.

The Law "On abolishing discrimination in the taxation of legal entities which use assets and capital of domestic origin" dated February 17, 2000 was a bolt out of the blue for taxpayers. According to this law, now enterprises in Ukraine with domestic or foreign capital are subject to the integral taxation regime. While adoption of this law shows the instability of tax legislation regarding foreign investors, its implementation will help to foster competition in Ukraine (see **COMPETITION POLICY**).

Equalising the tax burden

Greater equality in the tax burden was achieved thanks to the abolishment of several tax privileges. However, business entities operating in special economic zones, ore mining and smelting sectors, and enterprises of light and wood processing industries located in Chernivtsi oblast continue to receive special privileges

During the considered period of time, greater equality was achieved in distribution of the tax burden, due to several positive changes:

- According to the Law "On amending the Law of Ukraine 'On the value-added tax'" dated December 3, 1999, the zero VAT rate on coal, electricity, and imported natural gas was abolished.
- By the Law "On the State Budget of Ukraine for 2000", restructuring and write-offs of tax debts accrued from January 1, 2000 were prohibited.
- A law dated February 17, 2000 introduced a national taxation regime for joint ventures.
- According to the Law "On amending some laws of Ukraine on taxation" dated March 2, 2000, the VAT exemption for critical imports was cancelled.
- The law dated March 2, 2000 put an end to the privileged taxation of sales of vacation packages for sanatorium,and health resorts in Crimea.

However, the problem of unequal distribution of the tax burden still exists, with business entities operating in special (free) economic zones (see **SPECIAL ECONOMIC ZONES**), ore mining and smelting sectors, and enterprises of light and

wood processing industries located in Chernivtsi oblast continue to receive tax privileges.[9]

Reducing the tax burden

The existence of a large number of taxes, particularly sales taxes, results in a high tax burden on businesses, and impedes production expansion. Last year, Ukrainian authorities continued to cancel targeted levies

The existence of a large number of taxes, particularly sales taxes, results in a high tax burden on businesses, and impedes production expansion.

Shortening the list of taxes and levies

Last year, Ukrainian authorities continued to make decisions on cancelling targeted levies. According to the Law "On the State Budget of Ukraine for 2000", the levy for highway construction, reconstruction, repair, and maintenance[10] was abolished. As world oil prices have increased since the beginning of this year, it is rather difficult to measure the overall impact of this move on price dynamics for fuel and lubricants and tariffs on trucking. However, we expect the resources of enterprises in these industries to increase as a result.

According to the Cabinet of Ministers Resolution "On creating the Ukrainian State Innovation Company" dated April 13, 2000, collection of the levy to the State Innovation Fund will be halted on January 1, 2001. We believe that the abolishment of this levy—which is mandatory for all business entities—will lead to a significant reduction of the tax burden on the private sector.[11]

Imposition of a single levy collected at checkpoints on the national border of Ukraine might be considered progress in the area of tax system reform.[12] The single levy replaced 7 different fees which had been charged at the checkpoints (see **FOREIGN TRADE**). The Law "On amending Article 14 of

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[9] The Law "On conducting an economic experiment in order to stabilise performance of Chernivtsi oblast's enterprises of the light and wood processing industries" came into force on January 13, 2000. This law took the place of a similar Presidential Decree dated April 30, 1999.

[10] According to the Law "On financial sources for road services" dated September 18, 1991, "highways contributions" included a levy on the sales of fuel and lubricants (7%) and a turnover tax on automobile services (2%).

[11] In January–July 1999, revenues from the levy to the State Innovation Fund were 1% of GDP.

[12] The levy is collected according to the Law "On imposing a single levy which is paid at checkpoints on the national border of Ukraine" dated November 4, 1999.

the Law of Ukraine 'On the tax system'" dated November 4, 1999 added this levy to the fixed list of taxes and levies. This law also provides for transferring the collected revenues to non-targeted funds of the State Budget.[13]

At the same time, the government proposes to preserve in 2001 the additional levies to the Pension Fund that were imposed on a temporary basis. According to the Cabinet of Ministers Resolution "On development of the draft State Budget of Ukraine for 2001, its preliminary indicators, and activities for developing the draft Law on the State Budget of Ukraine for 2001" dated June 9, 2000, it is planned to extend the terms of the levy on cellular mobile telecommunication services and the levy on production and import of tobacco goods, and to increase the levy on hard currency-buying operations transferred to the Pension Fund from 1% to 2%.

A large number of minor taxes causes a heavier tax burden and higher compliance costs. Meanwhile, such taxes ensure only a small share of the budget revenues, and as a result their compliance costs outweigh any benefits.

Excise

Last year's excise tax rates and base underwent the most significant improvements:

- The number of excisable goods was shortened. According to the Law "On amending some laws on the taxation of excise goods (products)" dated November 4, 1999, foodstuffs (coffee, chocolate, sturgeon caviar), clothes, household appliances, and weapons were deleted off the list of excisable goods, allowing both taxpayers and tax agencies to cut administrative costs.
- Now excise rates will be set in hryvnias rather than in euros. Obviously, this will simplify calculation of taxes and protects excise rates from sudden fluctuations caused by exchange rate jumps.
- Excise rates were increased in order to compensate for the shortage of the excisable goods list. Excise rates on beer, strong drinks, and jewellery were raised. However, excise rates on tobacco products were reduced.

[13] See the Law "On the State Budget of Ukraine for 2000" dated February 17, 2000.

VAT refunds for exports

Procedures for the budget reimbursement of VAT on export operations underwent changes. The issue of VAT refunds was settled at the legislative level for the first time

Since the government did not meet its commitments concerning timely refunds of the VAT on export operations, it was hard for economic entities to plan their activities. Moreover, their tax burden became heavier. In order to solve this problem, on June 1, 2000 several amendments were inserted into the Law "On the value-added tax"; in particular, Article 8 titled "Peculiarities of the taxation of exportation (transmission) of goods (works, services) outside Ukraine's custom territory" was revised.

Changes in the procedures for budget reimbursement of VAT on export operations include:

- setting a term for VAT refunds to taxpayers (i.e., 30 calendar days from the date when the calculation of the reimbursement sum was submitted);
- determining the list of documents which should be enclosed to the calculation of a reimbursement sum (i.e., customs declaration or any other document denoting the fact of goods/service exportation or transmission, copies of receipts for purchased goods or services);
- if taxpayers have VAT arrears over the last tax periods, the arrears are set off against the budget refunds or their share;
- at the discretion of taxpayers, the sum of the budget refunds of export-related VAT may be accounted as payment of the VAT or other taxes and levies to the State Budget.

Thanks to these changes, the issue of VAT refunds was settled at the legislative level for the first time. We would like to emphasize that the determination of the 30-day term for VAT refunds and the right of voluntary choice in accounting the refund as payment of other taxes and levies are factors that now allow greater certainty in planning for businesses In Ukraine.

On the one side, the requirement to enclose customs declaration and copies of payment documents attested by banks to calculation, of VAT refunds means additional costs for businesses. On the other side, it will significantly obstruct cheating on the VAT refunds through the creation of bubbled companies. The minimisation of such illegal activities is one

of the prerequisites to ensure proper VAT refunds to honest taxpayers.

At the same time, it is worth noting that the Cabinet of Ministers Resolution "On some issues regarding value-added tax refunds and the regulation of payments to the budget" dated December 7, 1999, which contradicts the revised Law "On the VAT", is still in force. The document established the possibility for cross-offsetting VAT refunds against arrears to the budget.[14] As a result, taxpayers have poor incentives to keep discipline in paying taxes, because they are allowed to accumulate arrears, expecting that they will be paid off on the account of other taxpayers. In order to prevent collisions in the legal framework, the abovementioned resolution should be abolished.

Modifications in determining VAT base

The Law "On amending some laws of Ukraine on taxation" dated March 2, 2000 deleted the royalty from the VAT base. This innovation will promote the expansion of the scope for exercising intellectual property rights.

According to the Law "On amending Article 3 of the Law of Ukraine 'On the value-added tax'" dated December 21, 1999, a free cession of assets to the public or municipal domain by decision of state or local governments is exempted from the VAT. This will foster the completion of shifting public-sector property from enterprises to local governments.

The Tax Code

On July 13, 2000 the Verkhovna Rada adopted the key provisions of the draft Tax Code submitted by the Cabinet of Ministers. The objective of the code is to establish an integral tax system, which will be able to harmonise the interests of government and business. The Tax Code adoption should finalise the started modifications of Ukrainian tax legislation.

The Verkhovna Rada adopted the key provisions of the draft Tax Code submitted by the Cabinet of Ministers. The objective of the code is to establish an integrated tax system, which will be able to harmonise the interests of government and business

[14] According to the resolution, now there are the following variants for VAT refunds: (1) offsetting tax payment debts of taxpayers' creditors; (2) offsetting payments on loans which taxpayers or their creditors were granted under state guarantee; (3) at the expense of other taxpayers' assets seized as tax collateral.

Stability and predictability

The Tax Code is a tool for gathering all regulations on taxation into an integrated system and ensuring their coherence. As in Ukraine the development of the tax system has been a chaotic process, tax payments are regulated by legal acts at different levels. Moreover, these acts appertain to different sectors of the economy. The laws on personal income tax,[15] local taxes and levies, and rental fees[16] have not been adopted yet. The Tax Code should eliminate these disadvantages which hamper the development of a transparent tax system.

In its Resolution "On recognising the draft Tax Code of Ukraine as a framework" dated July 13, 2000, the parliament proposes to include levies for social funds in the tax system. This will impede the imposition of additional social levies; hence it will help to ensure greater predictability of the tax burden. The parliament is also pressing for declaring a 5-year moratorium on changes in the list of national taxes.

However, the draft Tax Code reserves the possibility for by-law development, which is a threat to the stability of the tax system. For instance, the government draft code provides the Cabinet of Ministers with the authority to determine rates, subjects, and base of taxation regarding rental fees, environmental levy, and (partly) property tax.

Equality in tax burden distribution

The Tax Code section on special regimes of taxation contains a list of privileges having no positive incentive for socially useful activities. This list includes the integrated tax for small-size business entities, the fixed agricultural tax, and privileged taxation for entities operating in special (free) economic zones.

The integrated tax and simplified system of taxation, accounting, and reporting for small business were imposed to cut down on compliance costs. According to the Resolution of the Verkhovna Rada dated July 13, 2000, the regulations on simplified taxation for small businesses should be pre-

[15] Taxation of personal incomes is regulated by a corresponding Cabinet of Ministers Decree. The level of nontaxed minimums is set by Presidential Decree.

[16] The rental fees on oil and natural gas are collected according to a Presidential Decree dated December 21, 1994; their rates are determined in the annual law on the state budget.

sented in the Tax Code in the current wording of the Presidential Decree "On the simplified system of taxation, accounting, and reporting for small business" dated July 3, 1998. Implementation of the decree has led to positive results, confirming the expedience of such a step.

The switch to the fixed agricultural tax allows simplifying tax administration in agriculture, because the tax is calculated based on units of land plots. In this case seasonal variations will have a weaker affect on the resource volume of agricultural enterprises. Compared to the Law "On the fixed agricultural tax" dated December 17, 1998, the draft Tax Code contains one useful innovation, i.e., the necessity to pay the tax in cash.

Privileges granted to business entities functioning in special economic zones are the greatest threat to the tax system in Ukraine. Since the draft code does not envision any change, all the weaknesses of the current legislation regarding special economic zones will be preserved (see **SPECIAL ECONOMIC ZONES**).

Reduction of the tax burden

Both the draft Tax Code and the Verkhovna Rada proposals reflected in the resolution dated June 13, 2000 will ensure the lessening of the tax burden on the private sector, thanks to the following moves: (1) shortening of the tax list; (2) reduction of the VAT rate from 20% to 15%;[17] (3) a softer control over costs in the process of income calculation; (4) a 30% ceiling on personal income tax.

If the Tax Code is adopted and parliament suggestions are included, the number of taxes and levies will be cut down from the current 35 taxes and 22 levies (mandatory payments).[18] The cancellation of sales taxes will increase producer capacity for responding to market conditions. Additionally, the tax proportion in prices will be smaller, so businesses will be able to develop more realistic price strategies.

If the Verkhovna Rada suggestions are accepted, the VAT rate will be reduced from 20% to 15%,[19] and the upper value

[17] In EU countries, the average VAT rate is 19.5%.
[18] However, we do not include the levies for state social and pension insurance.
[19] According to the Verkhovna Rada resolution dated July 13, 2000, during the first year after the Tax Code promulgation, the VAT rate will be 17%.

of taxed operations—exceeding of which means that taxpayers should register as VAT-payers—will be raised from 10.2 million hryvnias to 250 million hryvnias. We do not expect that lowering the VAT rate will result in price breaks. Nevertheless, the reduction will have another visible effect: thanks to the reduced VAT portion in goods prices, enterprise resources will increase.

When the VAT rate drops to 15%, enterprises will have incentives to expand production, therefore they will cut costs by economies of scale. The larger quantity of taxed operations and exceeded corporate tax revenues will partly compensate the budget losses caused by the reduced VAT rate.

If the ceiling of operation value that requires businesses to be registered as VAT-payers is raised, small firms will be able to reduce their compliance costs. This factor will encourage new businesses to enter the market and existing enterprises to expand their activities. Consequently, competition will increase, and consumers will benefit from wider range of goods and services, which will become cheaper.

The reduction of the tax burden on enterprises will be possible thanks to the softer control over costs[20] and the increased depreciation rate. These proposals were included in the resolution of the Verkhovna Rada dated July 13, 2000. At the same time, the Verkhovna Rada insists that the current 30% rate of corporate profit tax should be preserved.

The rate of corporate tax and the ceiling rate of personal income tax should be made even with regards to taxation of the self-employed individuals (private lawyers, consultants). It will help to develop fair competition between self-employed and registered entities functioning in the same sphere.

The Tax Code provides for reduction of the tax burden on individuals through two ways: (1) increasing every level of income taxed according to rates of progressive taxation;[21] and (2) limiting the ceiling tax rate to 30%.[22] These measures

[20] For instance, the Verkhovna Rada resolution dated June 13, 2000 contains a proposal to delete the regulation on the Cabinet of Ministers right to set norms on natural loss of commodities through taxpayer fault from the Tax Code. In this case, any amount of natural loss could be considered as gross costs.

[21] This issue has not been revised since October 1995.

[22] According to the Tax Code, three personal income tax rates of 10%, 20%, and 30% will be introduced. Currently there are five tax rates—10%, 15%, 20%, 30%, and 40%.

will stimulate the legalisation of hidden income and the growth of salaries and savings.

Urgent tasks

We believe that the most important tasks which call for harmonising the interests of different participants in the process of Tax Code adoption are the following:

- determination of the rights of taxpayers and the powers of tax agencies, particularly the application of taxpayer liabilities through the mechanism of tax collateral (see **REGULATION OF ECONOMIC ACTIVITY**). These issues have not been legislatively regulated yet;
- imposition of the property tax. There is still no consensus on the priority of tax goals in Ukraine: income redistribution or creation of incentives for more effective use of fixed capital. According to the Verkhovna Rada resolution dated July 13, 2000, the property tax should be levied on housing, while business property should be exempted from this tax. Under such conditions, property tax would become a means of income redistribution in society, but it would not encourage firms to sell their excess fixed capital, i.e., to use it more effectively;[23]
- reduction of the number of taxes and their rates will cause budget revenue losses. Thus, budget expenditures should be reviewed. Any delay in cutting down the amount of government responsibilities will hinder the successful realisation of tax policy reform.

[23] See *Quarterly Predictions* #10 (January 2000) p.17.

Foreign trade

The goal of Ukraine's foreign trade policy is to maximise the country's benefits from foreign trade through effective usage of its competitive advantages in worldwide resource allocation. At this stage, the priority objective of the policy is to accelerate integration into the global economy through (1) joining GATT/WTO and (2) entering the EU free-trade zone. WTO membership will give Ukraine the opportunity to increase its presence in international markets and obtain the right of full participation in the settlement of trade disputes between countries. Joining the EU free-trade zone will promote increased exports of certain merchandise and make Ukraine more attractive for investment. While the government has stated this objective as a priority of its external trade policy, the implementation remains inconsistent

The defined objective of Ukraine's foreign trade policy calls for harmonising Ukrainian legislation with the requirements of the GATT/WTO and the EU Partnership and Cooperation Agreement (PCA). The following changes in legislation should take place:

- gradual reduction of customs tariffs[24] and harmonisation of regulations on the use of non-tariff barriers to trade (particularly import quotas for agricultural produce) with WTO norms;
- promotion of competition by rejecting discriminatory protection strategy, e.g., export subsidies and unfair restrictions on imports;
- modification of customs procedures and the procedures for standardisation and certification (see **REGULATION OF ECONOMIC ACTIVITY**) according to world standards;
- ensured protection of intellectual property rights (see **INTELLECTUAL PROPERTY**).

Tariff and non-tariff regulation

Over the last 12 months, a large number of documents was approved with the aim of liberalising foreign trade:

[24] Rates of customs tariffs for foodstuffs, automobile engines, chemicals, textiles, footwear, cast iron, and steel deviate the most from WTO recommendations.

A large number of documents directed at foreign trade liberalisation was approved: the rates of import duties on some goods were reduced, the barriers to import of automobiles were lessened, and a single levy to be paid at checkpoints on the national border of Ukraine was imposed. However, import duties on certain goods were raised

- The rates of import duties on textiles, footwear and other light industry goods, as well as furniture, organic and inorganic chemicals, products of machine building, were reduced.[25]

- The Cabinet of Ministers Resolution "On bringing decisions of the Cabinet of Ministers of Ukraine into line with the EU Partnership and Cooperation Agreement" dated March 29, 2000 lessened the barriers to import. The resolution abolished the requirements for minimum customs value of imported automobiles, tobacco goods, alcoholic beverages, and products of agriculture and light industry. Moreover, the maximum age of imported automobiles was raised to 8 years.

- Obligatory licensing of imported medicines was cancelled according to the Cabinet of Ministers resolution dated August 31, 2000.

- The Law "On imposing a single levy which is paid at checkpoints on the national border of Ukraine" was adopted on November 4, 1999. The law will help to quicken customs passage at checkpoints and reduce its costs. Currently, the lion's share of time and money spent on transferring goods across the border falls at customs. However, the law was not coordinated with related regulations. As a result, it will come into force only in 2001, after the coordination process is completed.

However, the inconsistent nature of the external trade policy of Ukraine brings all the positive changes in legislation to naught. The contradiction of certain regulations with the declared policy of WTO accession creates ambiguity concerning the further development of legislation in this realm. For instance, import duties were raised on rolled metal, bars, and plates (resolution of the Cabinet of Ministers dated November 20, 1999), ferroalloys (resolution dated April 12, 2000), and automobile engines (resolution dated June 9, 2000).

[25] See the Cabinet of Ministers resolutions "On changing the rates of import duty on certain types of goods and amending some resolutions of the Cabinet of Ministers of Ukraine" dated September 27, 1999, January 15, 2000, January 24, 2000, and May 4, 2000; "On changing the rates of import duty on certain types of agricultural equipment and machines, and components" dated March 16, 2000; and "On changing the rates of import duty on certain types of goods" dated June 6, 2000.

Increased import duties cast doubt on Ukraine's intention to join the WTO. Countries preparing for such a move should not impose new trade limitations during the pre-accession period; they should only reduce customs tariffs in order to comply with WTO requirements. Moreover, the instability of customs taxation makes it more difficult for enterprises to plan their operations, i.e., worsen Ukraine's investment climate.

Competition

Protectionist policy in the domestic metallurgical and automobile industries and agriculture is an obstacle to developing competition in foreign trade. Barriers on grain exports were also imposed

The protectionist policy in the domestic metallurgical and automobile industries and agriculture is an obstacle to developing competition in foreign trade.

During the last 12 months, metallurgical enterprises were granted the following privileges:

- tax privileges for enterprises of the mining and smelting sector, determined by the Cabinet of Ministers Resolution "On the list of enterprises in the ore mining and smelting sector that participate in an economic experiment" dated October 1, 1999;
- restrictions on the export of scrap metal. By special order, as of August 10, 2000 the First Deputy Prime Minister Yuri Yekhanurov temporarily halted negotiation and customs registration of current contracts. The parliament is examining a draft law on banning the export of non-ferrous scrap metal, imposing a duty and quota on the export of ferrous scrap metal.[26]

Tax privileges in the metallurgical industry and restrictions on scrap metal exports practically translate to government subsidisation of enterprises of the mining sector. Such behaviour forces Ukrainian trade partners to apply compensatory sanctions. The restrictions on scrap metal export also create room for corruption, as the procedures for obtaining licences for operations with scrap metal are rather opaque.

Privileges granted to automobile manufactures are an obvious violation of the most-favoured-nation treatment regarding foreign trade that Ukraine should provide according to GATT/WTO requirements. Protection of the domestic automobile industry against international competition through restricting imports and granting additional privi-

[26] See *Quarterly Predictions* # 13(October 2000), p. 29.

leges[27] has short-term positive effects, including the creation of extra jobs and production growth. Its long-term effect is negative: (1) interests of consumers are hurt, as they have no possibility to select goods meeting their full range of tastes and incomes, (2) several companies have practically a monopolistic position due to privileges allowing them to manufacture products of lower quality and higher price than in a completive environment.

Besides protectionist measures, in order to reduce domestic prices on food the government resorted to foreign trade restrictions. Imposed by a presidential decree dated June 29, 2000, the mandatory registration of grain export contracts at exchanges specially accredited for this operation significantly limited the activity of Ukrainian grain exporters (see **SECTORAL REGULATION**). Although the corresponding Cabinet of Ministers resolution dated July 24, 2000 was promulgated, the exchanges did not register these contracts for a period of time due to the lack of a registration procedure, which came into force only on August 25, 2000. As a result, exporters could not carry out their contracts on time and had to pay penalties for ship delays in port. Now, for setting contracts at exchanges, exporters have to bear additional costs of 0.5%[28] of the contact value. Moreover, exporters have to spend much time on the registration procedure.

The Customs Code

A draft Customs Code should undergo second reading during the parliament's current session.[29] This draft complies with international standards in the realm of merchandise classification and codification, customs procedures (customs control, registration, estimation of customs value, determina-

[27] According to the Law "On the rates of excise and import duty on certain vehicles" dated May 24, 1995, sale turnover of cars, cargo and passenger transport, and motorcycles produced by Ukrainian manufacturer of all forms of ownership are exempted from excise till January 1, 2007 on the condition that these enterprises produce more than 1,000 cars and 1,000 motorcycles per year. According to the Law "On stimulating automobile manufacture in Ukraine" dated September 19, 1997, automobile manufactures with foreign investment of not less than $150 million are exempted from the VAT, import duties, and some other taxes.

[28] According to the data of the Ukrainian League of Entreprenuers of the Agro-Industrial Complex.

[29] The draft Customs Code passed first reading on May 13, 1998.

tion of the country of origin, etc.), and customs information. Thanks to the adoption of the new Customs Code which simplifies and makes customs procedures more transparent, Ukraine will be able to increase its foreign trade turnover.

A new draft Customs Code should undergo second reading during the Verkhovna Rada's current session. Thanks to the adoption of the new Customs Code, which simplifies and makes customs procedures more transparent, Ukraine will be able to increase its foreign trade turnover

The Customs Code contains the following innovations:

- The draft code covers areas of customs activity which previously were regulated by uncoordinated provisions.
- The draft code includes the Law "On the Customs Tariff of Ukraine".[30] The law stipulates that customs procedures should be equal for all countries, goods owners, and vehicles. It also should determine customs regimes[31] and conditions of their use in export-import operations. This will reduce the uncertainty of entities involved in foreign economic activity (FEA) about the forms and scope of tariffs and customs control in Ukraine.
- A new mechanism for setting and changing duty rates regarding the customs tariff was developed. The law on the customs tariff will define the maximum rates of duties on the basis of Ukraine's customs and tariff policy and obligations stipulated by international agreements. The Cabinet of Ministers has the right to change customs tariffs only within the limits established by law. Thus, FEA entities will be confident that the duty rates will not exceed a set level, and therefore will plan their operations more effectively.

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[30] The Customs Tariff of Ukraine is a set of duty rates on goods transferred across customs borders of Ukraine, systemised according to Ukraine's Commodity Tariff Nomenclature (based on the WTO's Harmonized Commodity Description and Coding System). The custom tariff includes a list of commodities; rates of import and export duties on goods covered by the Tariff Nomenclature; customs preferences used on the basis of international agreements and obligations; tariff preferences which Ukraine applies ex parte in favour of certain countries, country groups or their regions; and other privileges meaning reduced customs tariffs or temporary exemption from duty payment during the customs passage of certain goods into Ukraine.

[31] These regulations, fixed by customs legislation, determine the procedure for transferring goods and vehicles across the customs borders of Ukraine, and applying proper customs procedures against the aim of transference. There are 13 customs regimes, e.g., import, reimport, export, reexport, transit of goods, temporary import/export of goods, licence bonds, and processing. The current Customs Code of Ukraine lacks the concept of a customs regime.

- It is planned to introduce mandatory declaration of the customs value of goods and to cancel the minimum customs value. These steps will speed up the procedure for customs value estimation, as customs officials will recheck the declared information only if they have reasonable grounds. The application of the simplified procedure for customs registration is provided for FEA entities which do not violate the terms of goods transportation across borders during a certain period of time. Moreover, a simplified form of declaration for goods imported on a periodical basis (periodical customs declaration) will be introduced.

- In order to eliminate illegal imports and overcome the problem of intentional presentation of distorted information on goods value, customs agencies were entitled to exercise a posteriori control over FEA entities. At any time after the customs registration of goods and vehicles is completed, customs officials can check the correspondence of the actual use of these goods and vehicles throughout Ukraine's customs territory with the stated customs regime and the aim of use.

Importantly, the draft Customs Code enlarges the powers of the customs agencies, which were equated with law-enforcement powers. On the whole, the practice of granting these powers to customs agencies is widespread in the world and desirable for the optimisation of customs passage.

Legislation development prospects

To join the WTO and the EU free-trade zone, Ukraine should ensure the following changes in legislation on foreign trade:

- reduce import duties to the levels recommended by the WTO (customs tariffs for foodstuffs, automobile engines, chemicals, textiles, footwear, cast iron, and steel deviate the most from WTO recommendations);

- abolish restrictions on the export of scrap metal and grain, the export duty on sunflower seeds, hides, and livestock; and eliminate tax privileges for enterprises of the mining and smelting sector;

- adopt the Customs Code;

- improve the procedures for standardisation, certification, and accreditation (see **REGULATION OF ECONOMIC ACTIVITY**).

Competition policy

Special legislation which stipulates control over maintaining fair competition should be introduced in those spheres where market self-regulation is not able to promote competition. In the markets where natural monopolies operate, competition is distorted by huge initial investments and constantly decreasing unit costs. Procedures for government procurement on the basis of open tenders create conditions for developing competition in markets where the state is the main customer. Since the beginning of 2000, the Verkhovna Rada has adopted framework laws regarding natural monopolies and government procurement. The antimonopoly law is one of the first pieces of Ukrainian legislation; however, it requires the definition of antimonopoly bodies' powers and the regulation of their working procedures

Natural monopolies

The regulation of natural monopolies is hampered by the lack of an integrated strategy in this realm. Uncoordinated laws on transport, telecommunications, and energy sector regulation have been adopted; however, not long ago the Verkhovna Rada approved a framework law on natural monopolies

In Ukraine, the regulation of natural monopolies is hampered by the lack of an integrated strategy in this realm. Uncoordinated laws on transport, telecommunications, and energy sector regulation have been adopted; however, recently the Verkhovna Rada approved a framework law on natural monopolies.

The Law "On natural monopolies" dated April 20, 2000 established the concept of natural monopolies[32] and principles of their regulation. The prices for products of natural monopoly entities, and consumer access to these products, are subject to regulation.

The law envisions the creation of national commissions which will regulate the operation of natural monopoly entities. Thus, in additional to the National Electricity Regulation Commission,[33] at least two commissions—for transport and communications regulation—should be established.

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[32] According to the law, natural monopolies are markets where competition has no positive effect because unit costs are always reduced if product output grows. This law refers to the markets of pipeline transportation services, electricity transmission and distribution, infrastructure of railway, air, sea, and river transport, basic telephony services, centralised water supply, and sewerage as natural monopolies.

[33] The National Electricity Regulation Commission Regulation was created by a presidential decree dated March 14, 1995.

These commissions should regulate prices on the basis of recouping average costs by natural monopoly entities and protecting consumer rights. Moreover, the commissions should develop and introduce mechanisms for contestability between natural monopoly entities that would substitute competition.

Commission independency is an important factor in the successful regulation of natural monopolies. This regulation is aimed at harmonising the interests of consumers and natural monopoly entities. The commissions will be able to ensure this harmonisation if no outside players influence their decisions.

According to the law, the commissions are to be central executive bodies granted special status. The President of Ukraine appoints commission heads and members, as proposed by the Prime Minister. Commission heads and members will serve a six-year term. These conditions will ensure the independence of the commissions for natural monopoly regulation.

The independent regulation of natural monopolies and consistent measures in this realm are impeded by the law's provision stipulating that the commission's powers can be delegated to local governments. According to the law, the commissions' powers are delegated if natural monopoly entities direct their activity at satisfying the needs of certain regions. Overall application of this provision will create the possibility of local government interference in the sphere of natural monopoly regulation.

Government procurement

The Verkhovna Rada approved the Law "On the procurement of goods, works, and services with government funds" on February 22, 2000. The law will provide for delimiting the budget-funded and private sectors by the development of contract relations between budget-financed organisations and private companies. The law matches relevant EU directives and the WTO's Agreement on Government Procurement.

The Law "On the procurement of goods, works, and services with government funds" was adopted. The law will provide for delimiting the budget-funded and private sectors by the development of contract relations between budget-financed organisations and private companies. It will encourage more effective planning and use of budget resources

In our opinion, the law will favour competition thanks to the following procedures:

- preferring open tenders as the main method of government purchases. All interested enterprises acquainted with the tender announcement can participate in the

open tenders. Budget-funded principal-organisations should publish their announcements in the *Visnyk derzhavnykh zakupivel* (Government Procurement Newsletter) and other mass media;

- preparing tender documentation. Budget-funded principal-organisations announce tender requirements and the criteria for evaluating tender proposals. These criteria include the lowest price, term of delivery/fulfilment, product quality, after-sale services, terms of payment, etc. As far as possible, the criteria should be given in quantitative terms;
- disclosing the tender results and submitting an annual report on government procurement to the Verhovna Rada.

The law establishes equal terms of participation in government purchases for domestic and foreign contractors. However, according to the law, domestic contractors can obtain privileges if the procurement value does not exceed a defined limit.[34] This practice does not contradict the WTO's Agreement on Government Procurement.

The law will encourage more effective planning and use of budget resources. For example, in June 2000, the Ministry of Health Care created a tender committee and tender commissions in order to organise the purchase of medical equipment and facilities using budget funds.[35] This step should increase the effectiveness of its procurements. Meanwhile, on the part of principals and contractors the lack of required skills and knowledge prevents the rapid introduction of government purchases. As a result, their volume will be rather small at first. Government procurements will increase gradually thanks to the transition to planning public expenditures by means of programmatic budgeting.

Antimonopoly legislation

The antimonopoly law was one of the first pieces of Ukrainian legislation after independence. The laws "On restricting

[34] This limit amounts to 200,000 euro for goods, 300,000 euro for services, and 4 million euro for works.

[35] See the orders of the Ministry of Health Care of Ukraine "On creating the Tender Committee" dated June 8, 2000 and "On organising and conducting tenders on the centralised purchase of goods, works, and services" dated June 16, 2000.

monopolism and banning unfair competition in economic activity" and "On the Antimonopoly Committee" were adopted in 1992–1993. The provisions of these laws regarding the powers of the Antimonopoly Committee contradict both the Constitution and current legislation.

The antimonopoly law is one of the first pieces of Ukrainian legislation. Its regulations regarding the powers of the Antimonopoly Committee contradict the Constitution and the current legislation. Today, antimonopoly legislation is undergoing significant changes

The Verkhovna Rada approved the law "On amending the Law of Ukraine 'On the Antimonopoly Committee'" on July 18, 2000. The adopted changes brought the Law "On the Antimonopoly Committee" in line with articles 92 and 102 of Ukraine's Constitution. According to Article 92 of the Constitution of Ukraine, now the rules of competition and norms of antimonopoly regulation should be determined exclusively by laws of Ukraine.

A new version of the law increases the President's power in forming the Antimonopoly Committee. The President appoints and relieves the head of the Antimonopoly Committee in accord with the Verhovna Rada. (Earlier, the Verkhovna Rada made this decision alone.) According to the Prime Minister's proposal, the President also appoints and relieves deputy heads and government representatives. The new version of the law contains more accurate lists of the powers of government representatives and heads of regional Antimonopoly Committee offices.

In the near future, the Verkhovna Rada will examine the Law "On protecting economic competition" in second reading. This law should replace the Law "On restricting monopolism and banning unfair competition in economic activity". The need for a new law emerges from the objective of harmonising Ukrainian antimonopoly legislation with EU standards. At least two-thirds of the draft law are devoted to detailed regulation of the work of Antimonopoly Committee officials, in order to ensure effective protection of competition with minimum government interference in economic activity.

Special economic zones

The aim of creating special economic zones (SEZ) and priority development areas (PDA) is to foster economic development in depressed regions. SEZ can be used to facilitate attracting modern technologies to the national economy, promote the competitiveness of goods and services, expand exports, and create new job opportunities. However, international experience indicates that SEZ are not always effective–they may distort market competition and not attract expected investments. Nevertheless, SEZ can succeed if they are properly planned. Currently, Ukraine has 12 SEZ and 7 PDA, among which only 3 SEZ– in Donetsk, Lviv, and Transcarpathia oblasts–may be considered as relatively successful regarding attracted investments. This situation, compounded by the IMF requirements for competition development, explains why the issue of usefulness of SEZ in Ukraine has been widely discussed during the last 12 months. Nevertheless, no legislative move aimed at eliminating the roots of SEZ inefficiency has been launched

SEZ problems in Ukraine

The main problems of SEZ operation are (1) lack of clear and strict requirements concerning SEZ specialisation; (2) improperly large size of SEZ and PDA; and (3) opaque and unclear procedures for entering/exiting and excessive regulation of SEZ entity activities

The main problems of SEZ in Ukraine are as follows:

- lack of clear and strict requirements concerning SEZ specialisation, resulting in the unjustified expansion of privileges for practically all activities in the zone. Moreover, it harms competition in the domestic economy, as enterprises located in SEZ are granted non-competitive advantages over enterprises of the same sector located outside SEZ;
- improperly large size of SEZ and PDA, leading to distorted competition in the zones. Inequality between different areas within the territory of the zones increases, with more advanced areas attracting investors while the rest of the zone feels the shortage of investments. Thus, SEZ cause budget losses, and depressed regions still do not receive proper support. This situation is typical even for the relatively successful SEZ in Donetsk, Lviv, and Transcarpathia oblasts;
- opaque and unclear procedures for entering/exiting, and excessive regulation of SEZ entity activities. As a result, investment gains are lower than the costs involved, and investment inflow into the zone decreases.

During the last year, the process of SEZ and PDA creation in Ukraine continued. Three new special economic zones appeared: "Porto-Franko" (law dated March 23, 2000), "Reni" (law dated March 23, 2000), and "Mykolaiv" (law dated July 13, 2000); and the territory of the PDA in Zhytomyr oblast was granted a special regime for investment activity (law dated December 3, 1999). However, the low efficiency of existing SEZ and PDA forced the Cabinet of Ministers to impose a moratorium on the submission of proposals for new SEZ/PDA to the Cabinet (resolution dated September 24, 1999). The Cabinet of Ministers also appointed its representatives to the joint government and Verkhovna Rada committee that will study SEZ in full. Current SEZ/PDA study includes only monitoring SEZ entity activities. So, during the last 12 months, no particular methods for eliminating the reasons for ineffective SEZ operation were designed.

Specialisation

Recent changes in legislation did not encourage narrowing of zone specialisation

A narrow specialisation of SEZ entities would ensure minimisation of the negative effect on competition. However, in Ukraine the zones are not narrowly specialised.

The Ministry of Economy and the Ministry of Finance identified basic criteria for determining priority activities within the territory of SEZ/PDA (order/regulation dated March 14, 2000). However, this regulation had no real effect on SEZ/PDA functioning, because the established criteria are rather general and there is no mechanism for their implementation. Moreover, the document specifies the prospective development activities for the economic sectors of 11 oblasts, including practically all the oblasts' industries and agriculture. So, due to this factor, most zones remain without specialisation.

According to the Cabinet of Ministers rResolution dated July 26, 2000, the list of priority activities within SEZ/PDA was cut down. But this step will have no positive effect on the quality of SEZ/PDA functioning, as the list is still excessive. For example, it includes such activities as potato cultivation, livestock farming, clothes and shoemaking, etc., hence the rule of specialisation (meaning that SEZ should not distort competition in the domestic economy) is ignored.

Expansion of SEZ territory

Even though the PDA in Luhansk oblast operates inefficiently (in 1999 it attracted only one investment project), 2 additional cities and 2 raions were integrated into this PDA by a law dated November 18, 1999. This decision will only deepen the zone's inefficiency.

Ways to resolve problems

Overcoming the problem of SEZ/PDA inefficiency calls for measures aimed at the improvement of zone administration, which we recommended a year ago (see *Policy Studies* #7–8, 1999). Additionally the list of priority activities should be abridged, to define a narrow specialisation for every zone and to halt further SEZ/PDA expansion. Creation of new zones is inexpedient, as they will distort competition. Moreover, inefficient SEZ/PDA must be cancelled, but the government should retain all privileges already granted to economic entities. This step is needed in order to preserve Ukraine's reputation among foreign investors and ensure protection of their rights.

Intellectual property

Effective protection of intellectual property rights (IPR) will encourage foreign investments into Ukraine and stimulate the creation of domestic intellectual property. Development of legislation on IPR protection is one of requirements of the GATT/WTO and the EU Partnership and Cooperation Agreement. During the last year, in order to strengthen its international integration policy, Ukraine ratified several international agreement and expanded internal legislation on IPR protection. However, the most severe problem is the lack of mechanisms for legislation implementation

International conventions

On November 17, 1999 Ukraine acceded to the Paris Convention for the Protection of Industrial Property. On June, 1 2000 the Verkhovna Rada ratified the Madrid Agreement for the International Registration of Trademarks and the Nice Agreement for the International Classification of Goods and Services to which Trademarks are Applied.

However, the decisions on acceding to the international conventions are very likely declarative, as there is no real mechanism for their implementation.

Internal legal framework

According to international requirements, during the last 12 months Ukrainian legislation on the protection of rights to inventions and useful models was revised. Also, a law on copyright and allied rights to audiovisual works and recordings was adopted.

Industrial property

According to a law dated June 1, 2000, the Law "On protection of rights to inventions and useful models" was approved in a new redaction. This step was caused by inconsistencies in the law and the need to harmonise Ukraine's procedures for patenting inventions and useful models with international practices. The following innovations were introduced in the latest version of the law:

- The list of patent subjects was extended to include, e.g., new exploitation of existing products and methods.

- General procedures for submitting international patent applications were determined according to the Agreement on Patent Cooperation.
- Employers are now entitled to obtain patents for their worker's inventions; the proper patenting procedure was regulated.

The concept of a declarative patent for inventions was introduced. Declarative patents are granted for inventions of local novelty (contrary to worldwide novelty, required for ordinary patents). The term of declarative patents for inventions is 6 years (ordinary patents are granted for 20 years). The provisions should stimulate the appearance of national intellectual property.

Problems of legal regulation of intellectual property rights in Ukraine

Special contribution by Oleksandr Martynenko and Yulia Andrusiv, Baker & McKenzie (Ukraine)

The inadequacy of legal instruments for intellectual property right protection is an acute problem in Ukraine. The Ukrainian market is flooded with goods that are sold with IPR violations, particularly the right to trademarks, copyrights, and allied rights. Weaknesses of Ukrainian legislation often preclude individuals whose legal rights are violated from stopping these violations. First of all, customs legislation and regulations on protection against unfair competition should be significantly improved.

Ukraine actually lacks a mechanism for non-admission of goods imported with IPR violations to the customs territory of the state. Worldwide practices show that very this mechanism is one of the most important components of an effective system of IPR protection.

According to current legislation, goods imported with IPR violations shall not be passed through Ukraine's customs frontier (Article 74 of the Customs Code of Ukraine). The Cabinet of Ministers should submit a list of goods which are covered by this regulation to the Verkhovna Rada for approval. However, it is practically impossible to foresee what goods are imported with IPR violations, hence the usefulness of this list is doubtful. Thus, Article 74 of the Customs Code of Ukraine regarding product import with IPR violations is an impotent regulation.

According to Article 4 of the Law "On protection against unfair competition" dated June 7, 1996, use of alien trademarks and indicators that could create confusion with other commercial activity is an act of unfair competition.

The wording of Article 4 suggests that this regulation covers only direct usage of other business's trademarks and indicators. Therefore, in the case when used trademarks and indicators are not fully identical to those of competitors, but their similarity is so obvious that it can muddle consumers, the usage of such trademarks does not constitute an act of unfair competition. Meanwhile, the Law "On protection against unfair competition" was adopted in order to impose Article 10bis of the Paris Convention for the Protection of Industrial Property. This article envisions protection against the use of trademarks or indicators in the course of trade that are liable to mislead the public as to the nature, the manufacturing process, the characteristics, the suitability for their purpose, or the quantity of the goods.

Legal regulation of rights for trademarks calls for imposing regulation of Article 6bis of the Paris Convention for the Protection of Industrial Property. According to this article, the countries of the Union undertake the protection of trademarks considered by the competent authority of the country of registration or use to be well-known. In Ukraine, both the procedures for considering trademarks as well-known and the power to determine trademarks as well-known have not been fixed yet.

Another problem is the lack of clearly defined conditions in Ukraine for early cancellation of trademark certificates by reasons of non-use or insufficient use of the trademarks. According to Article 17 of the Law "On the protection of rights for trademarks" dated December 15, 1999, any individual can apply to court for ahead-of-schedule termination of a trademark certificate on the basis of the indicated reasons. At the same time, it is not known how to measure "sufficient" use of trademarks and how to distinguish "sufficient" and "insufficient" use.

In the future, the lack of a specialised court for resolving disputes regarding intellectual property rights in Ukraine will become a significant problem. Today, the judicial system is not able to deal effectively with cases on intellectual property, as judges have no specific knowledge, particularly regarding inventions and useful models. The issue of a specialised court should be resolved through adopting relevant provisions in the Law "On the judiciary".

Copyright

In order to protect copyright and allied rights, the Verkhovna Rada adopted the Law "On distributing copies of audiovisual work and recordings" on March 23, 2000. This law imposed control holograms for marking produced and imported audiovisuals. Control holograms are a sign of adhering to copyright and allied rights, also they grant the right for audiovisuals distribution.

The law establishes administrative responsibility for illegal distribution of audiovisual works and recordings. According to the law, audiovisual works and recordings should be sold retail only at specialised retail stores.

We believe that the law will allow discerning legal and pirated audiovisual products through the control holograms. At the same time, the law does not wholly solve the problem of the import and sale of pirated products, as there is no agency coordinating activity for the prevention and disclosure of copyright violations.

Contract enforcement

The problems of Ukrainian legislation on contract enforcement are (1) insufficient integrity of this legislation, (2) ineffectiveness of property liability mechanisms, and (3) slow progress on judicial reform. During the last 12 months, legislation pertaining to contract enforcement underwent no changes. A new version of the Civil Code of Ukraine, which passed second reading in the Verkhovna Rada, is the most remarkable event of this period

Integrity of legislation

The legislation which should ensure the coordination and reliability of economic activities is not integral. The current Civil Code does not include conditions for private business creation and operation. The definition of an enterprise is grounded on ownership of separate property rather than on property rights. A new Civil Code has passed second reading. However, imposition of the Economic Code, approved in first reading, is a significant risk

Legislation on contract enforcement should ensure the coordination and reliability of economic activities. However, in Ukraine corresponding legislation is not integral as there is a delay in adopting a new version of the Civil Code. The current Civil Code dates to 1963 and does not even foresee conditions for private business creation and operation. The definition of an enterprise (legal entity) is grounded on the ownership of separate property rather than on property rights.

The goal of a new Civil Code[36] is to set uniform rules of the game in the realm of property relationships, on the basis of an even playing field for all business entities and their freedom of choice to enter these relationships. The new version of the code contains the following important norms:

- definition of a legal entity.[37] Legal entities are classified as subjects of private law or subjects of public law. Legal entities of private law are organisations created and managed by private individuals or businesses. Legal entities of public law are organisations created by the state. It is established that public legal entities obtaining property rights are also subject to the code's regulations. Therefore, the Civil Code ensures the equality of all legal entities, both public and private;
- the right of individuals to engage in business, and property liability of individual entrepreneurs;

[36] The draft Civil Code passed second reading in the Verkhovna Rada of Ukraine on June 8, 2000.

[37] According to the draft code, legal entities are organisations that can have property rights, other property and personal non-property rights, can bear responsibility and be a plaintiff or defendant in court.

- intellectual property rights. A separate volume of the new Civil Code is devoted to regulations on intellectual property rights;
- overall contract provisions and a detailed description of types of obligations. These code regulations will promote quality contracts between economic agents; and
- legal status of financial derivatives and securities (options, futures/forward contracts, and depository notes).

The code will call for significant changes in current legislation, particularly the adoption of laws on joint-stock companies[38] and special pieces of legislation regarding procedures, organisational-legal forms, and legal status of public companies.

The Economic Code of Ukraine, which passed the reading on June 8, 2000, threatens the integrity of legislation ensuring contract enforcement. The regulations of the draft code pave the way for government interference in the economy. The draft Economic Code violates the rule of equal rights for subjects of the law, containing articles on state support to some enterprises, tax privileges, price regulation, etc. Moreover, if the Verkhovna Rada adopts the code, this document will likely play the role of unnecessary intermediary between the Civil Code and laws regulating business relationships.

Property liability

A new version of the law "On bankruptcy" came into force on January 1, 2000. Imposition of the new law, however, is still ongoing. Half a year later, the Ministry of Economy approved the Order "On the organisation of work for licensing arbitrage managers". According to the order, the ministry's department of property and bankruptcy should organise the work of licensing arbitrage managers. As the law stipulates, arbitrage managers are the main participants in the bankruptcy process.[39]

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[38] According to the draft Civil Code, organisational and legal forms of enterprises created in order to obtain profit are economic entities (joint-stock companies, partnership with limited or additional liability, unlimited companies, and *komandyty*) or producers' cooperatives.

[39] Arbitrage managers act as asset-managing agents, reorganisation (*sanatsiia*) managers, and liquidators.

Successful implementation of the new version of the bankruptcy law is impeded by unequal treatment of different business entities that is predetermined by the law. For example, the law's application is limited regarding state-owned enterprises that could not be privatised, public enterprises,[40] and "communally owned" companies. Integral property complexes of state enterprises cannot be sold during the process of reorganisation. A law dated November 18, 1999 suspends the law on bankruptcy of coal-mining, coal-processing, and coal-mine building enterprises.[41] The bankruptcy procedure will not foster the development of comprehensive methods for overcoming the problem of bad loans.[42]

A new version of the Law "On bankruptcy" came in force on January 1, 2000. Imposition of the new law, however, is still ongoing. Successful implementation of the new version of the bankruptcy law is impeded by the unequal treatment of different business entities

Introduction of the new Civil Code will encourage expansion of opportunities for using property liability instruments. The draft code defines the property rights of legal entities and stipulates that legal entities are liable with all their property. As the draft Civil Code determines equal rights for subjects of private and public laws, the abovementioned regulations of the draft code cancel the limitations regarding usage of integral property complexes of state enterprises as collateral[43] and their sale during the process of reorganisation. The risk of abolishing such limitations is the possibility of unsupervised privatisation of state-owned enterprises happening through bad bargains set by enterprise managers, which could result in enterprise incapacity to meet contract obligations. In order to minimise this risk, a clear mechanism of accountability of public enterprise managers to the owner—the state—should be developed and implemented.

Introduction of the new Civil Code will support the expansion of opportunities for using property liability instruments

The judicial system

In our opinion, businesses in Ukraine are not inclined to defend their rights in court because of high court costs and the low effectiveness of the court system.

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[40] According to the Law "On enterprises", public enterprises are state-owned enterprises whose products are consumed mainly by the government, or natural monopolies.

[41] According to the bankruptcy law, there is a moratorium on applying the bankruptcy procedure to agricultural enterprises.

[42] The law provides for the following options: pre-court *sanatsiia*, *sanatsiia* (reorganisation, restructuring, sale of integral property complex), liquidation, or peace pact. See *Policy Studies*, #7–8 (July–August 1999), p.33.

[43] This limitation is in force according to the Law "On collateral" dated October 2, 1992.

In Ukraine, businesses are not inclined to defend their rights in court because of high court costs and the low effectiveness of the court system. Meanwhile, the judiciary reform required by Ukraine's Constitution has been postponed

The law dated November 18, 1999 reduced the costs of court process; the rates of the state fee for property claims were lowered from 5% to 1% of suit value.

Recently, the number of cases heard in commercial courts has increased. As a result, court loading now exceeds capacity. Taking this fact into account, the President imposed the Decree "On creating panels of judges on examining cases of tax and levy (compulsory payment) collection at commercial courts of Ukraine" on August 13, 1999. According to the decree, commercial court staff was increased.

Meanwhile, the judiciary reform required by Ukraine's Constitution has been postponed. The Verkhovna Rada rejected the draft "On the judiciary" as unacceptable on March 2, 2000. A people's deputy group submitted a new draft law, which is now being prepared for first reading. By a decree dated August 30, 2000, the President established the Board on Judicial System Reform; chaired by the President of Ukraine, it will be responsible for coordinating work on a draft law on the judiciary. These measures will help to reach political consensus on judiciary reform in Ukraine.

Court independency and hierarchy are the most disputed issues in judicial system reform. Court independency is the precondition for realising the principle of equal rights for all subjects of the law, which is provided by the new Civil Code of Ukraine. The issue of court hierarchy emerges from creation of specialised courts and their subordination to the Supreme Court of Ukraine.

According to the draft law on the judiciary, commercial and administrative courts are considered as specialised courts in Ukraine. Judge specialisation for different cases could be introduced in courts, which would encourage a more effective court process.

The draft law provides for the following hierarchy of commercial courts: local commercial courts, the Appeal Commercial Court, and the Supreme Commercial Court. Appeal courts hear appeals cases. The Supreme Commercial Court hears reviews and appeals, it also generalises judicial practices, and develops explanatory notes and recommendations regarding legislation application.

The Supreme Court of Ukraine is the court of last resort. It hears cases, including commercial court cases, in appellate order. The Supreme Court commission, involving judges of

the Supreme Court and chairmen and judges of specialised courts, makes all decisions.

The opportunity for appealing court decisions at different levels will ensure higher quality of protection of business entity rights. Thus, the independency of courts, particularly those of last resort, is a prerequisite for an effective appeal system.

The creation of an arbitration tribunal could assist in lightening commercial court overload. Today, the regulations on the arbitration tribunal for resolving economic disputes between associations, enterprises, organisations, and institutions, which were approved by the National Arbitration Court at the USSR Council of Ministers on December 30, 1975, is still in force. The most effective arbitration tribunal is the International Commercial Arbitration Court at the Chamber of Commerce and Industry of Ukraine.[44] A draft Law "On the arbitration tribunal" should be considered in order to expand the sphere of arbitration tribunal influence.

[44] The Law "On the International Commercial Arbitration Court" was approved on February 24, 1994.

Privatisation and the stock market

In Ukraine, privatisation carries out several functions. First, privatisation is a tool for attracting investments and increasing the effectiveness of the economy. Second, it is an important source of state budget revenues. Third, privatisation is still the main source of public companies for the stock market of Ukraine. Modifications in legislation regarding privatisation should be evaluated from these basic viewpoints. During the last year, privatisation legislation underwent positive changes, thanks to the consensus on privatisation policy reached by the President, the government, and the Verkhovna Rada majority. Meanwhile, the government and parliament failed to develop a proper legal framework for state and municipal property management. Also, legislative problems pertaining to the stock market and its infrastructure still remain to be solved

Privatisation

Privatisation program

The Presidential Decree "On priority measures for the acceleration of privatisation in Ukraine" significantly speeded up the development of legislation regarding privatisation. In May 2000, the Law "On the State Privatisation Program" was adopted. Later, the Ukrainian authorities took several important steps to speed up privatisation process in some sectors

The Presidential Decree "On priority measures for the acceleration of privatisation in Ukraine" significantly speeded up the development of legislation regarding privatisation at the end of December 1999. This document provided for both strong acceleration of the privatisation process, thanks to an increased number of entities proposed for sale, and the introduction of reform innovations in the privatisation procedures—in particular, a focus on selling shares to strategic investors without investment liabilities and a 100% sale of Ukraine's medium-size enterprises. The decree was also of ideological importance, as it demonstrated the position of the re-elected President with regard to privatisation. With the political stability established after the presidential election, the approval in May 2000 of the Law "On the State Privatisation Program", based on the presidential decree, was a logical next step.

The State Program on Privatisation was the main and most reformatory legal document adopted last year in the realm of privatisation. The approval of the law by the Verkhovna Rada was very important, because the parliament had refused to support privatisation programs over the last two years. This discouraged investors from participating in privatisation in Ukraine. The approved program will be effective for at least 3 years—from 2000 to 2002—which diminishes the risks that

privatisation legislation will be amended. According to the program, state property may be sold only for cash. The approved privatisation plans envision that proceeds from the sale of state property will amount to 2.5 billion UAH in 2000, 1.5 billion UAH in 2001, and 1 billion UAH in 2002.

The new program focuses on selling shares to strategic investors, and grants the State Property Fund of Ukraine (SPF) the authority to search for buyers and select the method of sale. To attract strategic investors, the program eliminates investment conditions for tender sales. It reserves only one necessary restriction—that strategic enterprises can be sold to industrial investors only, chosen on the basis of their interest to retain a market share of the privatised enterprises (requirements to investors are stated in the program).

The program also restricts the right to retain share packages in the hands of the government. The program allows the government to manage only 25%+1 and 50%+1 share packages of the monopoly enterprises or strategic entities for the three-year term (compared to five years).

The program also determined the fate of several thousand share packages of medium-size enterprises. Stakes which the government held in theses firms did not allow them to reorganise through bankruptcy procedures, for example. According to the new rules, the SPF will sell residual shares to privileged shareholders for half of face value if no buyers have been found in the market. If shareholders refuse to purchase shares, the privatisation body will initiate the reduction of the statutory capital to the size of the state's share package, which will be voted on at the shareholder meeting.

However, the privatisation program preserves the rudiment of "mass privatisation"—privileged sales. Employees and retired workers of privatised companies have the right to buy shares of their joint-stock companies for half of their face value, to a maximum amount of 45 untaxed minimal [monthly] wages. Managers of these enterprises can also purchase another 5% of shares for half the face value (today, 45 untaxed minimum wages amount to 756 UAH).

Privatisation in some sectors

The Law "On the particularities of Ukrtelekom privatisation", approved in July 2000, was a long-expected breakthrough in the privatisation process. This decision will help to collect the forecast privatisation proceeds in 2001–2002 and also to attract investments in Ukrainian telecommunications and to

give powerful incentives to the stock market. However, the law's disadvantage is that the share package to be sold is limited to 49% of the statutory capital (in fact, licences rather than shares should be the tool of government control). Another weak spot of the law is the provision stipulating that after privatisation, the state's share in Ukrtelekom will be increased. The law assumes that 30% of the amount paid by the buyer will be invested in the company by the state through buying additionally issued stock. In this case, the investors' share in the statutory capital would decrease. Currently, the Verkhovna Rada is examining a draft law abolishing this provision.

On a separate note, the Verkhovna Rada approved the draft law "On the particularities of privatisation in the fuel and energy complex" in first reading. This law should speed up the privatisation process in this industry. According to presidential decree, followed by corresponding decisions made by the government and the SPF, the remaining 25% of [state] shares of seven oblast energy-distributing companies (oblenergos) will be sold. This has allowed proposals of 60–75% controlling share packages of these companies for sale.

The Law "On the particularities of privatisation of incomplete construction", approved in September 2000, is another positive move. The law stipulates the following privileges for buyers, overcoming a number of problems: (1) delayed payment for a period of up to five years, with interest attached to inflation rates; (2) tax exemption for transactions related to the privatisation of incomplete construction; (3) permission to consider expenditures on construction as total costs while calculating profit tax; and (4) a land tax exemption (this privilege lasts as long as the construction continues).

The Law "On the particularities of privatisation of enterprises managed by the Ministry of Defence of Ukraine", approved in May 2000, is rather difficult to justify by economic calculation. The law does not clearly indicate who (except for management of the Ministry of Defence) and why will buy shares of these enterprises, because the plan of their allocation envisions (1) not less that 51% of shares to be retained in the hands of the government; (2) privileged sales on the basis of conditions determined by the Ministry of Defence; and (3) purchase of another 15% of shares by officials of the Ministry of Defence. Practically all privatisation proceeds will be directed at the needs of the ministry.

Another negative example is the approved special privatisation plan for the Mariupol Illich Metallurgic Works as a law. The plan envisions the purchase of the state share package by the managers and workers of the plant, who already hold 43% of all shares. The justification of this privatisation strategy was given as the good performance of the enterprise, outstanding professional skills of the director, and the possibility of conflict among shareholders and consequent worsening performance if the state package is purchased by investors who do not get on with the current management of the plant.

Moreover, the approved law created a precedent of legislative interference in the privatisation of some enterprises, which infringes the principles of competitive privatisation adopted in Ukraine. Besides, the workers and managers do not possess the capital or modern technologies that strategic investors can bring in.

Lastly, during the past year the Verkhovna Rada approved laws amending the Law "On the privatisation of state property". Thus, the list of legal entities under state ownership which are not subject to privatisation was extended to include plant variety testing stations and districts, other organisations assessing crop varieties, as well as the assets of grain-receiving and grain-procurement enterprises which are part of the statutory capital of the Khlib Ukrainy state joint-stock company. To implement the ambitious plan of privatisation for 2001–2002, this list should be shortened, as it contains too many enterprises and the principles governing their selection are unclear.

State property management

The Presidential Decree "On changing the system of central government" dated December 15, 1999 was the main document in the realm of state property management. This decree liquidated the National Agency for State Corporate Rights Management. The eighteen-month period of the Agency's functioning proved that, by its nature, the institution's activity was actually directed against privatisation, since it promoted the expansion of state interference in the economy and creation of non-transparent schemes, generating corruption. Delegating the agency's functions to the State Property Fund is a positive step on the part of Ukraine's executive, since it clearly defines the priority of privatisation over state property management.

The government failed to develop a strategy regarding state property management. However, during the last year, it closed several institutions whose activities were actually directed against privatisation, since they promoted the expansion of state interference in the economy and creation of non-transparent schemes, generating corruption

Another positive step was the Presidential Decree "On the Derzhinvest Ukrainy joint-stock company" that liquidated this company, which ineffectively managed the share packages that were part of its statutory capital. The same problems are typical for scores of other state holding companies. The Cabinet of Ministers created a working group to address the problems regarding expediency of their functioning.

However, liquidating the National Agency for State Corporate Rights Management and significantly decreasing the number of state-owned entities do not by themselves eliminate the problems of state property management or attracting investment to these enterprises. The government has still not developed a proper strategy for state property management.

The Cabinet of Ministers Resolution "On state corporate rights management", approved in May 2000, officially abolished all the old legal framework regarding state property management. However, approved new documents have not contained any fundamental innovations. They have not resolved the key problems in this realm: (1) ensuring guarantees for entities managing state property; or (2) rewarding management depending on performance, as currently officials in this area have only one incentive—access to the financial and material assets of enterprises. Neither did the resolution make the procedures for selecting state property management agencies transparent or competitive.

We hope that these disadvantages will not be maintained in the law regarding state-owned entities management, which passed second reading in the Verkhovna Rada but was not adopted.

The need for a law "On municipal property" is also extremely important; unlike for state property, a legal framework for municipal property has not been developed yet. This problem hinders reforms in the energy sector and the social sphere, as well as the creation of effective executive and local governments in Ukraine.

Stock market infrastructure

Last year, Ukrainian authorities failed to provide a proper legal framework for the stock market, and market players are still waiting for the adoption of several laws.

First of all, a new conception on stock market development in Ukraine should be adopted. The previous conception dates

to 1995, hence, today legislation on the Ukrainian stock market is practically not integrated and lacks a development program. The draft law "On institutions for mutual investing (unit and corporate investment funds)" is furthest along with regard to adoption among the special draft laws pertaining to the stock market infrastructure. This law should ensure a market transition from attracting vouchers to attracting cash from new investment funds, which should be more transparent and less risky. It can also encourage new players to enter the market—venture funds—that do not have the right to attract citizen savings and invest in the most risky projects without disclosing the name of fund owners.

Discussions of the draft laws "On securities and the stock market" and "On derivative securities" have gone on for several years; these draft laws are now out of date and need to be renewed. The all-important draft Law "On joint-stock companies" has not been able to pass by the Verkhovna Rada. This draft law optimises the ownership structure in Ukraine, which was gradually created according to the privatisation process and hence does not account for all innovations in the special legislation on the stock market.

Last year, Ukrainian authorities failed to provide a proper legal framework for the stock market and its infrastructure. The conception on stock market development in Ukraine was not updated. The Verkhovna Rada did not approve the laws "On institutions for mutual investing", "On securities and the stock market", "On derivative securities", and "On joint-stock companies"

Framework codes can also significantly modify the legal parameters governing the stock market. In particular, the Civil Code will determine the concept of security, which is basic for the stock market. For its part, the Tax Code will stipulate where market agents will receive more profits—directly in Ukraine or through offshore companies.

After being sharply criticised by the President of Ukraine in April 2000, the State Commission on Securities and the Stock Market accelerated its legislative activity regarding deregulation, shareholder protection, simplification of procedures, and increased market transparency. Due to its legislative activity, the commission has a large scope for market development that it had earlier not used effectively. For example, in June 2000, the commission supported the interests of minority shareholders and officially clarified the application of existing shareholders' priority rights to additional issues of shares. The commission determined that all shareholders have the priority right to purchase shares of additional issues, proportionately to their stake in the statutory capital. Failure to fulfil this condition is sufficient to deny registration of the issue. Formerly, additional issues of shares were the main tool to remove unwanted shareholders from company management.

Sectoral regulation

Agriculture

Documents regulating the agricultural sector that were adopted over the last twelve months can be split into two groups: (1) documents that determine property rights and (2) documents that regulate activities in the agricultural market

Documents for the regulation of the agriculture that were adopted over the last 12 months can be split into two groups: (1) documents that determine property rights and (2) documents that regulate activities in the agricultural market. The first group aims to create conditions that encourage effective management, while the second promotes the profitability of agricultural activities. All these documents have a common positive feature—the development of the agricultural sector based on market principles. On the other hand, the documents are declarative and sometimes inconsistent; they also do not guarantee the implementation of the declared issues.

Property rights reform (privatisation)

Property rights reform is the cornerstone of agricultural reform in Ukraine. Private ownership by itself cannot guarantee a rapid increase in productivity. Still, it can create the needed stimuli, since it makes producers fully responsible for the results of their activities. The following two documents contribute significantly to property rights reform in Ukraine:

- Presidential Decree "On urgent measures to reform the agriculture" dated December 3, 1999.
- Draft Land Code of Ukraine, approved in first reading on July 6, 2000.

The Presidential Decree of December 3, 1999 initiated an extensive and rapid reform of property rights

The Presidential Decree of December 3, 1999 initiated an extensive and rapid reform of property rights in the agricultural sector—the mass privatisation of land and reorganisation of collective agricultural enterprises (KSPs). The decree did not actually create any new legal procedures for the reorganisation of KSPs or land privatisation (compared to legislative acts effective at that time).[45] The right to private land owner-

[45] The only innovation was that the decree reinforced the role of the land certificate. According to the decree, during contract arrangements for rental of land plots (shares), the land certificate for the right to shares is a legally binding document testifying to the right to possess, use, and dispose of said plots. Alas, the benefit of this innovation is dubious, because if conflicts should arise, the courts may still invalidate rental operations pertaining to plots having no proper [state] land title ("act testifying to the right to own land").

ship was put into existence as early as in 1992, when the Land Code was amended. Many employees of KSPs had already exercised their right to withdraw from KSPs and demarcated their land plots before this decree was adopted. Rather, the decree was intended as an organisational and political document that outlined the state policy for land market creation and functioning of the private sector, and set time limits for the implementation of needed measures. Although the decree was entirely declarative, it did become a document of direct action, as almost all KSPs were reorganised into private enterprises of various organisational and legal forms.

The Land Code is the framework document that determines rights to land ownership

The Land Code, approved in first reading on July 6, 2000, is the framework document that determines rights to land ownership. It determines the forms of land ownership; conditions of acquiring the right to own land; legal entities, their rights and liabilities; rules of land plot circulation; and the classification and composition of lands.

According to the Code, land can either be owned or used. The forms of land ownership are state, communal, and private.[46] The forms of use are lease and permanent concession.[47]

The most celebrated part of the new Land Code is the affirmation of the right to sell and purchase land plots as a means to acquire the right to land ownership. At the same time, foreigners and those who are not citizens of Ukraine are deprived of the right to own land plots. These restrictions do not concord with international norms accepted in this area, and create opportunities for rent seeking. They also result from a political compromise, because granting foreigners the right to land ownership may become a significant impediment to the approval of the Land Code as a whole.

Another positive feature of the new Land Code is that it regulates the land collateral issue. The introduction of land collateral is an important condition for entities in the agricul-

[46] Collective land ownership–essentially, land owned by a collective enterprise–has been deleted from the new Land Code. Now enterprises acquire the right to own land either as private legal entities, or through state/communal ownership.

[47] According to the new Land Code, only state enterprises, institutions, and organisations can exercise the right of permanent concession.

tural sector to acquire loans.[48] The article devoted to the mortgage issue is rather general and requires the adoption of a separate law on mortgaging. Nevertheless, the fact that this issue is in the Land Code is grounds for the development of mortgage mechanisms.

The draft code fails to incorporate the issue of joint ownership of agricultural lands, which should have become a legal foundation for operations (primarily leasing) with large land plots. This issue remains unresolved, as the general provisions of the code state that a group of individuals can own a land plot based on the right of joint ownership only if a piece of joint immovable property is located on this plot.[49] One of the transition provisions states that owners can receive their land plots in a block, if they wish.[50] It cannot create sufficient legal grounds for leasing operations with large land plots.

The document introduces a useful concept of land servitude regulating the right to limited use of alien land plots. The draft law contains a detailed list of the types of land servitudes and determines the legal regime of their use. This concerns possibilities to access land plots while carrying out public works or fulfilling environmental protection measures. Land servitude is not the only means to exercise the right to use alien land. Internationally accepted mechanisms are *superficies* (the right to build on alien lands) and *emphytheusis* (the right to use alien lands for agricultural needs). The Land Code leans room for significant amplification in the part concerning the right to limited use of land plots.

Agricultural commodity market

The second important part of agricultural reform is the development of the agricultural commodity market. It aims to set regulations that would bring the interests of society and private businesses into accord. A number of documents on the functioning of the agricultural market were approved over the past year, primarily presidential decrees and the government resolutions. The most important of them are:

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[48] Besides the purchase-and-sale agreement, Ukrainian citizens can acquire the right to land ownership through devolution; rent-free transfer of state and communal lands; and privatisation of land plots by lessees (see Article 11 of Chapter 3 in the draft Land Code).

[49] See Article 15, Part 1 of the draft Land Code.

[50] See paragraph 8 of the Transition Provisions of the draft Land Code.

- Presidential Decree "On measures to ensure the creation and functioning of the agricultural market" dated June 6, 2000;
- Presidential Decree "On urgent measures to stimulate production and development of the grain market" dated June 29, 2000;
- Cabinet of Ministers Resolution "On encouraging activities in the exchange market for agricultural commodity and input supplies" dated October 19, 1999 (amended through a resolution dated June 2, 2000);
- Cabinet of Ministers Resolution "On measures to improve grain market regulation" dated July 20, 2000;
- Cabinet of Ministers Resolution "On new approaches to providing agricultural producers with inputs" dated January 17, 2000.

During the last year, a number of documents was approved in order to develop the agricultural market infrastructure. However, due to their declarative nature and self-contradiction, these documents are practically unable to ensure for achieving their stated goal

According to these documents, the development of the agricultural market infrastructure is an important task of government policy. And though all the documents aim at this goal, they do not stipulate mechanisms that would help to achieve it. Major pitfalls are the declarative nature and the inconsistency of the new acts.

1. DECREES AND RESOLUTIONS AIMED AT DEVELOPING THE AGRICULTURAL MARKET ARE DECLARATIVE. They declare market principles but do not propose measures that will make them work. In particular, the documents encourage the emergence of infrastructure enterprises and transparency of trade. Meantime, instead of creating stimuli, documents focus on controlling measures, which are especially severe with respect to trade operations.

The government argues that new measures are needed to reinforce control. Under this slogan, it imposed a ban on the export of grain if the export contract has not been concluded at an exchange.[51] This measure conflicts with market principles, including freedom of choice and fair competition. Nowhere in the world is the sale of goods forced to be exercised through an exchange, since they are created to simplify transaction procedures and provide trading parties with additional guarantees.[52] If Ukrainian exchanges can provide

[51] See Presidential Decree dated June 29, 2000.

[52] In particular, the availability of grain at a given address, of declared quality.

these guarantees at a reasonable price, trading parties will be willing to conclude agreements through exchanges. Today, they are forced to do this by means of administrative measures. The direct (and obviously well-planned) effect of these measures is shrinking export volumes and the enrichment of the exchanges at the expense of other agents of the agricultural commodities market. Thus, the market only tightens and does not develop as the approved documents declare.

Another example of declarative documents is a number of normative acts that prohibit state and local administrations from imposing restrictions on the movement of grain. These are undoubtedly illegal, yet tacit bans on the transportation of grain outside oblast bounds have been effective over the whole of this year. Moreover, the Ukrainian government issued a resolution in early 2000 that prohibited central and local authorities from interfering in the procedure that agricultural enterprises choose to pay for input supplies;[53] this resolution has been constantly violated.[54]

2. NEW LEGISLATION ON THE DEVELOPMENT OF THE AGRICULTURAL MARKET IS INCONSISTENT. The approved documents prohibit central and local authorities from interfering in pricing in the agricultural market. Meanwhile, the task is set to ensure the parity of prices, which in practice is equivalent to direct interference. While the government prohibits imposing restrictions on the relocation of grain products, it recommends "to strengthen control over the flows of wheat and other grains". The President aims to "ensure that the law on restricting the monopoly power and preventing unfair competition in entrepreneurial activities is properly enforced", while the government grants the Khlib Ukrainy state company the monopoly right to buy grain.[55] Khlib Ukrainy has been granted the monopoly right by the Ukrainian government to carry out state pledged purchases of grain.[56]

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[53] Resolution of the Cabinet of Ministers dated January 17, 2000.

[54] The Kharkiv oblast administration issued on an order whereby agricultural enterprises should deliver their payments to creditors in July 2000. This was a verbal resolution. Loans which had been given by local and regional budgets were to be repaid in the first turn, energy bills in the second, and bank loans in the third. Only after these repayments were made, enterprises could pay the owners of land and other assets, pay wages, and fulfil to other lenders.

[55] Presidential Decree dated June 6, 2000.

[56] The Cabinet of Ministers Resolution dated July 20, 2000.

Other important normative acts were adopted over the last year, and though they have not affected the agricultural market yet, they will be very influential in the long run. Among these documents are the Cabinet of Ministers resolutions on bank lending to agricultural enterprises, approved in the spring of 2000.[57] Volumes of bank loans remain negligible, because the default risk is still high, while the land collateral mechanism has not become effective yet. The future pricing support mechanism established by Presidential Decree dated June 29, 2000 has not come into effect, either. It prevents grain prices from falling in case of overproduction and thus supports domestic producers, but Ukraine seems not likely to take this step in the near future. The gap between future and market prices (if the latter become lower) should be covered at the expense of budget funds. Neither the size of these funds nor a mechanism for covering the gap were envisioned in the 2000 budget.

These documents form the framework for lending and pricing issues to be addressed in agricultural commodities market policy. Bank lending mechanisms will become effective when the land market emerges and mortgage instruments develop. The importance of price support schemes will grow in line with increased agricultural output, fairer competition, and overall economic growth, which will enable the government to support these schemes at the expense of budget.

Energy sector

During the last 12 months, legislation pertaining to contract enforcement in the electricity market underwent fairly positive changes. However, these modifications appear to be insufficient to prevent "manual adjustment" in the distribution of funds in the sector

During the last 12 months, legislation pertaining to contract enforcement in the electricity market underwent fairly positive changes. However, these modifications appear to be insufficient to eliminate opportunities for "manual adjustment" in the distribution of funds in the sector. Over the year, the Cabinet of Ministers and the National Electricity Regulation Commission (NERC) have taken many decisions contradicting the letter and the spirit of the Law "On electricity". For example, permission was granted for mutual debt offsets (a non-cash payment method), and procedures for fund distribution in the electricity market changed constantly.

[57] The Cabinet of Ministers Resolution "On additional measures for lending for spring fieldwork in 2000" dated February 25, 2000 and the government resolutions on procedures for granting banking loans to the enterprises of this sector and their volume dated March 1 and 7, 2000.

Contract enforcement in the electricity market

At the start of the year, the main problem in the electricity market was the failure of market agents to meet their commitments. The share of cash payments for delivered electricity did not exceed 10%. This problem was caused by (1) non-payments in the wholesale electricity market and (2) non-payments on the part of consumers.

To overcome the payments crisis, incentives and the regulatory environment in the electricity sector had to be changed. To provide market incentives, the government accelerated privatisation of electricity-supplying companies (see **PRIVATISATION AND THE STOCK MARKET**). However, only when the time-consuming privatisation of electricity-generating companies is completed will the incentives of all agents in the electricity market change. The legislative conditions for functioning in the electricity market play a very important role; they should legally eliminate opportunities for non-payments both in the wholesale electricity market and in the chain "electricity-supplying company–end consumer".

A half-year discussion of ways to reform the Ukrainian electricity market resulted in amendments to the Law "On electricity", which were approved on June 22, 2000; they eliminate the majority of reasons for non-payments, and simultaneously increase the rights of the government to interfere in the activities of wholesale electricity market agents.

Amendments to Article 15, Article 24, and Article 26 are the most important, and they envision the following:

- The wholesale energy supplier is required to conclude purchase-and-sale agreements with all other agents of the wholesale electricity market.
- The status of distribution accounts of supplying companies has been legally determined, and the mechanisms for distributing funds accumulated on these accounts.
- Supplied electricity should be paid for only in cash, through distribution accounts.
- The NERC receives the right to appoint administrators at electricity supplying companies, irrespective of their form of ownership.

Purchase-and-sale agreements will improve payment discipline in the electricity market, because previously no court could force debtors pay their liabilities in the absence of

these agreements, and thus the status of the Electricity Market Agreement was dubious.

However, the issue of distribution accounts is more complicated. The amendments minimise opportunities for "manual adjustments" in the distribution of funds by the government in the electricity market, and make the NERC responsible for determining the distribution formula. However, the NERC does not have sufficient independency to resist the pressure of constant "fire fighting". Members of the NERC are appointed by the President for a 6-year term; however, according to the regulations on the NERC,[59] this commission should be guided by government resolutions. During the second half of 2000, the NERC constantly modified the mechanism for fund distribution according to government instructions.

This allows the government to continue "manual" distribution of revenues in the electricity market. To prevent this possibility, the NERC should be assured independent status, as stated in the Law "On natural monopolies".

Finally, controversial amendments to Article 24 envision the possibility to appoint administrators at electricity-supplying companies. According to government resolution No. 1139 dated July 19, administrators can perform the functions of the board of such companies. Given these powers, administrators' activities could lead to bankruptcy. This decision contradicts Article 41 of the Constitution of Ukraine, which proclaims the right of private ownership to be inviolable, and can easily dissuade investors. If the appointment of administrators is considered as a measure to stop the non-execution of commitments by electricity-supplying companies, then court mechanisms, particularly the mechanism of bankruptcy, should be applied instead.

In the sphere of the retail electricity market, the Cabinet of Ministers Resolution "On approving the Rules for the population using electricity" dated July 26, 1999 (with amendments dated October 26, 2000) is an important step to ensure contract enforcement by electricity suppliers and individual consumers. This document envisions mandatory contracts between electricity suppliers and individual consumers. The resolution stipulates that suppliers have no right to refuse to

[59] Presidential Decree "On measures to ensure the activity of the National Electricity Regulation Commission" dated 14 March 1995.

conclude contracts with any consumers residing in the territory served by the suppliers. This restricts electricity suppliers' possibilities for abuse of their monopolistic position.

The Cabinet of Ministers Resolution "On ensuring discipline of payments for used natural gas, heat energy, and electricity" dated January 17, 2000 (with amendments dated May 5 and November 3, 2000) was aimed at creating conditions for contract enforcement in the retail electricity market. The government stated that consumers should receive that volume of electricity for which they paid according to contracts. By the May 5 amendments, the government finally abolished the list of consumers which must be granted subsidies to pay for electricity. As the government failed to ensure this condition, these consumers received electricity free of charge.

Forms of payment for electricity

The amended Article 26 of the Law "On electricity" stipulates that delivered electricity should be paid for in cash through distribution accounts. It significantly restricts the opportunities for non-cash payments. However, over the year the Cabinet of Ministers made a lot of decisions contradicting the letter and the spirit of the law

The amended Article 26 of the Law "On electricity" stipulates that delivered electricity should be paid for in cash through distribution accounts. It restricts opportunities for non-cash payments used in order to transfer budget funds, and resources of state enterprises in favour of certain individuals.

A government resolution dated May 7, 2000 was also directed at overcoming this problem. The resolution abolished 23 resolutions and directives regarding non-cash payments in the fuel and energy industry. Meanwhile, the Cabinet of Ministers Resolution "On conducting payments in the fuel and energy industry" dated July 12, 2000 allowed mutual debt offsets between the government, energy companies, and their contractors—for example, coal-mining enterprises or Ukrzaliznytsia [state railways enterprise]. During the following months, the government made several such decisions. Thanks to increased transparency and limited use of the non-cash scheme, they caused fewer total losses compared to the resolutions abolished in May; offsets and non-cash payments with the participation of the public sector led to ineffective allocation of budget funds. These decisions contradict Article 26 of the Law "On electricity", and market agents have already taken the opportunity to file court appeals.

To put an end to non-cash payments for electricity, a Law "On the procedures for collecting taxpayer debts to budgets and state targeted funds" should be adopted. This law should abolish the *Kartoteka-2* system [allowing seizure of funds on debtor accounts] and unblock the accounts of enterprises having tax debts to the state budget.

Banking sector

Banking sector regulations aim to ensure the effective allocation of financial resources in the economy and to prevent bank crises. Banks require special attention due to the following: (a) failure of the banking system can significantly slow down activities throughout the economy; and (b) effectiveness of the banking sector determines the soundness of economic policy, particularly monetary policy.[60]

Major problems of banking regulation in Ukraine are instability and the requirement to perform fiscal functions. Frequent changes in regulations, coupled with the application of administrative measures, diminish the attractiveness of the banking sector for investors

Major problems of banking regulation in Ukraine are instability and the requirement to perform fiscal functions. Frequent changes in regulations, coupled with the application of administrative measures, diminish the attractiveness of the banking sector for investors. Fiscal functions and failure to maintain bank secrecy scare away potential clients, who instead turn to grey intra-bank payment schemes, thus making the economy function less effectively.

Capitalisation

A sensitive issue in the regulatory framework of the sector are the requirements for the minimal size of statutory capital for commercial banks and economic justification of these requirements. On the one hand, the NBU recommends setting the minimum size of statutory capital at levels that would be in accord with international standards—in particular, the recommendations of the Basel Committee.[61] In that case, the number of commercial banks in Ukraine might shrink and produce the economies-of-scale effect, while both foreign partners and domestic clients would become more confident that their assets are well-managed and secure.

At the same time, this will also lead to closures of small commercial banks, including solvent and economically viable ones. Therefore, opponents of this norm point out the relatively smaller scale of the Ukrainian economy and doubt the expediency of international benchmarks. They also argue that the banking system will grow in line with the economy, and that artificial attempts to consolidate the system do not guarantee greater economic effectiveness.

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[60] Carl-Johan Lindgren, Gillian Garcia, and Mathew I. Saal. *Bank Soundness and Macroeconomic Policy,* International Monetary Fund (1996).

[61] Draft law "On banks and banking activities" sets the minimal size of capital at 25 million UAH.

Denomination of statutory capital is another important issue. Effective regulations do not envision mechanisms to protect already-deposited capital, which shrank significantly (if denominated in the euro) over 1998–1999, due to the devaluation of the hryvnia. In our opinion, it is expedient to set the minimal capital size in euros and to introduce the structural currency position, i.e., to keep part of the capital in foreign currencies. This change should be introduced gradually, to avoid excessive pressure on the exchange rate.

Although a consistent policy for capitalisation had not been developed over the year, the NBU changed the existing norms and approved:

- the procedure for excluding incomplete reserves from asset-side operations while calculating the size of bank capital.[62] The order simplifies the assessment of bank performance for both the inspection body of the NBU and partners at the bank;
- the procedure for allowing banks to calculate borrowed funds as a part of capital, attributing them to a subordinated debt.[63] Banks can borrow funds on the condition of subordinated debt for at most 5 years, at interest that does not exceed the NBU discount rate. The lending party must not be the bank's debtor, must not call away their money, or receive loans from the bank while the agreement is effective. In case of bankruptcy, the bank pays out the subordinated debt to the investor after all other creditors' claims are satisfied (but before equity holders). A minus of the order is the provision that requires calculating the amount of subordinated debt obtained in foreign currencies at the NBU exchange rate effective on the transfer date. Although this is unfavourable for investors, banks seek to obtain funds in the form of subordinated debt and thus avoid tedious procedures of registering contributions to the statutory capital;
- the requirement to increase the size of capital to 5 mil-

[62] Resolution of the NBU "On amending and supplementing the Instruction on the procedure for regulation and analysis of commercial bank activities" dated July 27, 1999.

[63] Resolution of the NBU Board "On approving the Procedure for allowing banks to calculate borrowed funds as a part of capital, attributing them to a subordinated debt, and on amending the Instruction on the regulation and analysis of commercial bank activities" dated October 25, 1999.

lion euros by November 1, 2000 for banks that want to confirm their licenses of opening correspondent accounts in non-resident banks and hold LORO-accounts in the national and foreign currencies.[64] This norm creates stimuli for consolidation of the banking system.

Fiscal functions of commercial banks

Commercial banks experienced significant difficulties in keeping bank secrets. A resolution of the NBU Board dated December 14, 1999 obliges banks to inform the State Tax Administration regarding transfers of money abroad and on LORO/personal accounts, and cash payments by specific legal entities (except wage payments). The access of fiscal authorities to bank information without a court decision restrains the development of the bank sector, since the possibility of information disclosure scares away potential clients.

Asset management

Over the last year, the NBU has improved the norms that ensure stable functioning of the banking system, in particular, the asset management regulation. The resolution of the NBU Board "On the new procedure for creation and use of reserves to secure losses associated with credit operations" dated July 6, 2000 establishes credit operation rules which emphasise the need for austere monitoring of clients by banks. Banks will have to form larger reserves because:

- classification of credit operations has become stricter;
- beginning January 2001, banks must form credit risk reserves for correspondent accounts at other banks, and for 30-day overdue interest and principal payments which were not written off the balance sheet.

Clients seeking loans will undergo a more complicated procedure. On the one hand, it complicates the financing of economic activities and document circulation; on the other, it helps to reduce the number of non-performing loans and creates proper relationships between the bank and clients.

The resolution of the NBU Board dated May 26, 2000 has also affected stimuli to lend. It classifies banks according to capitalisation levels and determines reasons and the proce-

[64] Resolution of the NBU Board "On amending and supplementing the Resolution on the procedure for giving banks licenses to perform banking operations" dated October 22, 1999.

dure in which the NBU applies measures for the infringement of banking legislation. According to the resolution, a negatively classified loan portfolio (a criterion for classifying banks according to capitalisation levels) includes "substandard" loans. As the majority of loans to domestic businesses can be classified as "substandard", we do not expect lending activities to increase significantly without structural reforms.

The resolution of the NBU Board dated March 15, 2000 extended the list of legal entities and individuals considered as insiders.[65] According to the resolution, insiders are companies which own 10% of a bank (compared to the previous benchmark of 20%). Insiders also comprise legal entities and individuals who can influence the decision-making process of a bank (even if they are not equity holders), if this can be proved by evidence.

The resolution of the NBU Board dated December 22, 1999 restored the right of commercial banks to obtain loans nominated in foreign currencies (restrictions were imposed in the fall of 1998), which is another measure for financial market liberalisation after the 1998 crisis.

Effectiveness of monetary policy instruments

The new rules of foreign exchange trade in the inter-bank market set by Resolution of the NBU Board dated December 13, 1999 restricted commercial bank speculations in the market. Previously, banks could both buy and sell foreign exchange in the inter-bank market. Banks should announce their net position at the beginning of the trading day and act either as a buyer or seller. And though this change reduces the flexibility of commercial bank operations, we consider it expedient from the standpoint of exchange rate stability.

The Law of Ukraine "On amending the Law of Ukraine 'On the National Bank of Ukraine'" dated July 13, 2000 also facilitated the implementation of monetary policy. It deprived the NBU Council of the status of NBU supreme administrative body and allowed the NBU to write arrears off banks' accounts to meet its own liabilities. From now on, the NBU has the unconditional right to satisfy any claim associated with refinancing a commercial bank, on the claim's maturity date. This allows improving the control over monetary aggregates.

[65] Current legislation restricts insiders' operations with the bank and prohibits giving them privileges.

Prospective changes

The new Law "On banks and banking activities" is a document that can eliminate a lot of the sector's problems (the draft passed first reading on June 1, 2000). Firstly, the draft law envisions that the norms currently formulated as bylaws will acquire the status of legislation. Banking regulation will become more stable, because issuing a law is a more complicated procedure than creating branch acts. Secondly, banks will disclose bank secrets only by permission of the bearer of information, or according to the respective court decision, which will increase the confidence of economic agents in the banking sector. The draft law also envisions classifying banks as multi-purpose, savings, investment, clearing, and mortgage banks, which allows introducing regulations that will consider the specifics and risks of activities of each type.

At the same time, the draft law creates a different procedure from the one in effect for bank liquidation, in case of insolvency. This also envisions that the NBU may decide on compulsory liquidation of a bank. The norm of the draft law that grants the NBU the right to enforce compulsory reorganisation in case of "evidence of bank's insolvency", can put significant pressure on banks, because the term "evidence of bank's insolvency" is not determined in the draft law.

In our opinion, the following steps should be made in the sphere of banking regulation:

- Improve and approve the new Law "On banks and banking activities".
- Fulfil the tasks mentioned in the Presidential Decree "On measures for reinforcing the banking system of Ukraine and increasing its role in economic transformation processes" dated July 14, 2000. It is necessary to adopt legislative acts that would protect creditors' rights and ensure borrowers' responsibility for targeted usage and timely reimbursement of borrowed funds. These include the laws "On crediting", "On circulation of bills of exchange in Ukraine", and "On the insurance fund for individuals' deposits", as well as amendments to the laws "On mortgage" and "On bankruptcy".
- Approve new editions of the Civil Code and Land Code.

List of evaluated legislation[66]

Regulation of economic activity			
Law of Ukraine	"On licensing certain types of economic activity"	dated June 1,2000	№ 1775-III
Law of Ukraine	"On amending the Law of Ukraine 'On using electronic cash registers and sales books in transactions with customers in trade, catering, and the services sector'"	dated June 1,2000	№ 1776-III
Law of Ukraine	"On amending the Law of Ukraine 'On financial accounting and reporting in Ukraine'"	dated June 22, 2000	№ 1829-III
Law of Ukraine	"On amending the Law of Ukraine 'On state statistics'"	dated July 13, 2000	№ 1922-III
Law of Ukraine	"On amending the Law of Ukraine 'On using electronic cash registers and sales books in transactions with customers in trade, catering, and the services sector'"	dated July 13, 2000	№ 1927-III
Presidential Decree	"On measures to ensure the redemption of debts to budgets and state targeted funds, and the repayment of loans"	dated December 24, 1999	№ 1617/99
Presidential Decree	"On introducing an integrated regulatory policy in the sphere of entrepreneurship"	dated January 22, 2000	№ 89/2000
Presidential Decree	"On additional measures to strengthen the fight against hiding untaxed incomes, and also laundering illegally earned profits"	dated June 22, 2000	№ 813/2000
Presidential Decree	"On approving the Regulations on the State Tax Administration"	dated July 13, 2000	№ 886/2000
Presidential Decree	"On measures to support business activity and its further development"	dated July 15, 2000	№ 906/2000
Cabinet of Ministers Resolution	"On approving the Methodological recommendations on preparing substantiations for draft regulatory acts"	dated May 6, 2000	№ 767
Cabinet of Ministers Resolution	"On creating the Council of Business Associations at the Government Committee on Economic Development"	dated May 18, 2000	№ 822
Cabinet of Ministers Resolution	"On approving the Regulations on the procedure for drafting regulatory acts"	dated July 31, 2000	№ 1182
Cabinet of Ministers Resolution	"On ensuring the redemption of budget losses caused by repayment of foreign loans gained by the state or granted under state guarantees"	dated September 21, 1998	№ 1466
Order of the State Tax Administration	"On changing the Procedures for forming corporate profit declaration"	dated June 12, 2000	№ 306

[66] Researched involved legislation which was in force on December 1, 2000.

Taxation policy			
Law of Ukraine	"On imposing a single levy which is paid at checkpoints on the national border of Ukraine"	dated November 4, 1999	№ 1212-XIV
Law of Ukraine	"On amending Article 14 of the Law of Ukraine 'On the tax system'"	dated November 4, 1999	№ 1213-XIV
Law of Ukraine	"On amending some laws of Ukraine on the taxation of excised goods (products)	dated November 4, 1999	№ 1214-XIV
Law of Ukraine	"On amending the Law of Ukraine 'On the rates of excise and import duty on tobacco products'"	dated November 19, 1999	№ 1246-XIV
Law of Ukraine	"On amending the Law of Ukraine 'On the value-added tax'"	dated December 3, 1999	№ 1274-XIV
Law of Ukraine	"On amending Article 3 of the Law of Ukraine 'On the value-added tax'"	dated December, 21 1999	№ 1330-XIV
Law of Ukraine	"On conducting an economic experiment in order to stabilise performance of Chernivtsi oblast's enterprises of light and wood processing industries"	dated January 13, 2000	№ 1375-XIV
Law of Ukraine	"On abolishing discrimination in the taxation of legal entities which use assets and capital of domestic origin"	dated February 17, 2000	№ 1457-XIV
Law of Ukraine	"On the State Budget of Ukraine for 2000"	dated February 17, 2000	№ 1458-III
Law of Ukraine	"On amending some laws of Ukraine on taxation"	dated March 2, 2000	№ 1523-III
Law of Ukraine	"On amending the Law of Ukraine 'On the rates of excise and import duty on certain goods (products)'"	dated March 23, 2000	№ 1581-III
Law of Ukraine	"On amending the Law of Ukraine 'On the rates of excise and import duty on ethyl alcohol and alcoholic beverages'"	dated March 23, 2000	№ 1582-III
Law of Ukraine	"On amending the Law of Ukraine 'On the value-added tax'"	dated June 1, 2000	№ 1783-III
Presidential Decree	"On the Regulations on the Ministry of Finance of Ukraine"	dated August 26 1999	№ 1081/99
Resolution of the Verkhovna Rada	"On recognising the draft Tax Code of Ukraine as a framework"	dated July 13, 2000	№ 1868-III
Cabinet of Ministers Resolution	"On creating the Ukrainian State Innovation Company"	dated April 13, 2000	№ 654
Cabinet of Ministers Resolution	"On some issues regarding value-added tax refunds and the regulation of payments to the budget"	dated December 7, 1999	№ 2215

Foreign trade			
Cabinet of Ministers Resolution	"On changing the rates of import duty on certain types of goods and amending some resolutions of the Cabinet of Ministers of Ukraine"	dated September 27, 1999	№ 1798
Cabinet of Ministers Resolution	"On the list of enterprises in the ore mining and smelting sector that participate in an economic experiment"	dated October 1, 1999	№ 1820
Cabinet of Ministers Resolution	"On imposing new rates of import duty on certain types of goods"	dated November 20, 1999	№ 2105
Cabinet of Ministers Resolution	"On approving the Procedure for conducting investigations directed at disclosing facts of discriminatory and/or unfriendly actions from other states, customs unions and economic associations regarding the legal rights and interests of entities of foreign economic activity in Ukraine"	dated November 22, 1999	№ 2120
Cabinet of Ministers Resolution	"On changing the rates of import duty on certain types of goods and amending some resolutions of the Cabinet of Ministers of Ukraine"	dated January 15, 2000	№ 40
Cabinet of Ministers Resolution	"On changing the rates of import duty on certain types of goods and amending some resolutions of the Cabinet of Ministers of Ukraine"	dated January 24, 2000	№ 121
Cabinet of Ministers Resolution	"On changing the rates of import duty on certain types of agricultural equipment and machines, and components"	dated March 16, 2000	№ 499
Cabinet of Ministers Resolution	"On bringing decisions of the Cabinet of Ministers of Ukraine into line with the EU Partnership and Cooperation Agreement"	dated March 29, 2000	№ 575
Cabinet of Ministers Resolution	"On changing the rates of import duty on certain types of goods"	dated April 12, 2000	№ 640
Cabinet of Ministers Resolution	"On changing the rates of import duty on some goods and amending some resolutions of the Cabinet of Ministers of Ukraine"	dated May 4, 2000	№ 751
Cabinet of Ministers Resolution	"On changing the rates of import duty on certain types of goods"	dated June 6, 2000	№ 926
Cabinet of Ministers Resolution	"On changing the rates of import duty on certain types of goods"	dated June 9, 2000	№ 936
Cabinet of Ministers Resolution	"On amending Cabinet of Ministers Resolution №1928 dated October 19, 1999"	dated July 24, 2000	№ 1152
Cabinet of Ministers Resolution	"On amending Cabinet of Ministers Resolution № 4 dated January 6, 2000"	dated August 31, 2000	№ 1357
Competition policy			
Law of Ukraine	"On the procurement of goods, works, and services with government funds"	dated February 22, 2000	№ 1490-III

Law of Ukraine	"On natural monopolies"	dated April 20, 2000	№ 1682-III
Law of Ukraine	"On amending the Law of Ukraine 'On the Antimonopoly Committee'"	dated July 13, 2000	№ 1907-III
Special economic zones			
Law of Ukraine	"On amending Article 3 of the Law of Ukraine 'On the special regime for investment activity in priority development areas of Luhansk oblast'"	dated November 18, 1999	№ 1241-XIV
Law of Ukraine	"On the special regime for investment activity in priority development areas of Zhytomyr oblast"	dated December 3, 1999	№ 1276-XIV
Law of Ukraine	"On the 'Reni' special economic zone"	dated March 23, 2000	№ 1605-III
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The **POLICY STUDIES** journal was established by the International Centre for Policy Studies in January 1999. **POLICY STUDIES** presents the results of policy research carried out by ICPS experts, partners, and other think tanks.

POLICY STUDIES is financed by the Open Society Institute.

Editor of **POLICY STUDIES:** Maksym Mashliakivsky
English version editor: Yevhenia Yehorova
Copy editor: D. (Ksenia) Ovcharenko

Our special thanks for assistance and advice go to employees of the Centre.

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Printed in Ukraine by Pekotoff-print

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